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"The Contribution of Management Buy-ins to Corporate Restructuring: Concepts, Characteristics and Performance"

by Ken Robbie, M.A.

Thesis submitted to the University of Nottingham for the degree of Doctor of Philosophy, October 1993

DECLARATION

This is to attest that no material from this thesis has been included in any work submitted for examination at this or any other university.

For My Mother

THE CONTRIBUTION OF MANAGEMENT BUY-INS TO CORPORATE RESTRUCTURING: CONCEPTS, CHARACTERISTICS AND PERFORMANCE

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ABSTRACT

The Contribution of Management Buy-ins to Corporate Restructuring: Concept, Characteristics and Performance

From the mid-1980s many UK venture capitalists, as an extension to their involvement in management buy-outs, made investments in management buy-ins where they backed new managers to purchase equity stakes in an existing company. This Thesis analyses the corporate restructuring and entrepreneurial influences behind buy-ins taking note of turnaround and venture capital influences. It draws on general buy-in characteristics from a database of 750 management buy-ins and the results of a representative questionnaire survey of 59 management buy-ins (mailed in Febnruary 1990) and backed by individual case studies. It is hypothesised that management buy-ins are a distinctive corporate restructuring form and have major differences with management buy-outs. Buy-ins are shown to be significantly different from buy-outs in terms of source, activity and realisation; they are more likely to be bought from a private source and to end up in receivership. Financing structures are more conservative but not on a statistically significant basis. Buy-in teams are smaller than in buy-outs, frequently have initial skills gaps, and in a minority of cases are led by second time entrepreneurs. The target company is normally identified through informal networks. Buy-ins are followed by a significantly higher degree of action in financial, product and marketing areas than Buy-outs and other restructuring processes such as turnarounds. Compared to US LBOs more attention is paid to working asset management with little unbundling of fixed assets and higher capital expenditure. Team Leaders are shown to be mainly opportunist in terms of entrepreneurial typology with a minority craftsmen and, unexpectedly, a few mainly motivated by push factors. This is in contrast to buy-outs where a typology is developed showing a preponderance of craftsmen.

Overall performance after buy-in was below original Business Plan but heavily influenced by adverse economic and financial conditions. Different types of Team Leaders were not associated with significant differences in performance although opportunists were more likely to be acquisitive. Contrary to the principles of corporate restructuring, discriminant analysis showed equity ratchets and higher rates of leverage being negative influences on profitability. Case studies showed ineffective monitoring and control by some venture capitalists. Buy-ins of privately owned companies, where there are particular problems of information assymetery, and those bought in the late 1980s where unrealistically high prices may have been paid for the target company were poor performers. Among entrepreneur related variables, the team's knowledge of each other was an important positive influence but education was negative.

PREFACE AND ACKNOWLEDGMENTS

My interest in the general area of corporate restructuring and management buy-outs and buy-ins goes back to some time before I joined the Centre for Management Buy-out Research at Nottingham University. Although having had an interest in the general area of employee share ownership, my first real contact with the implications of management buy-outs was buying a house near Cambridge in 1980 from a Managing Director of a privately owned company who was a forced seller of the house because of the needs to finance both a divorce and a management buy-out. It also brought an indication of the success and failure aspects: after an initially prosperous period, the move to a new factory and the Porsche, the company went into receivership in the late 1980's.

Practical experience came from the divestment of subsidiaries at the Elbar group to management teams. Between Elbar and Nottingham I was interested in a book published by my cousin on the subject and written by a certain Mike Wright and John Coyne! The period also saw me investigating management buy-in possibilities.

Management buy-ins however did not really feature in my first eighteen months at Nottingham. By 1987 they were beginning to be noted and certain venture capitalists expressed interest in a similar exercise being done for buy-ins as the Centre had started for buy-outs. Following a specific approach from David Hutchings of Midland Bank Equity (now Montagu Private Equity) I produced the first statistical and issues report on Management Buy-ins which was published at the time of the initial Management Buy-in Conference, held BRI in London. Not too long after this the Centre's sponsors were persuaded to include the statistical monitoring of buy-ins as an essential aspect of the

Centre's work on buy-outs. I also determined to follow buy-ins as a personal specialist research subject leading to my Buy-in survey and this thesis.

Earlier versions of some parts of this thesis have already appeared in various published forms and formed the basis for various conference proceedings:

Chapter 2.2- The Restructuring Opportunity in M. Wright, S. Thompson, B. Chiplin, K. Robbie, Buy-ins and Buy-outs: New Strategies in Corporate Management, Graham and Trotman (1991);
Chapter 5- Background characteristics of buy-ins in B. Chiplin, M.Wright and K.Robbie', The Annual Review from CMBOR', 1988, 1989, 1990, 1991, 1992;
Chapters 6-11- Descriptive results of the MBI survey in K. Robbie, M. Wright and B. Chiplin, Management Buy-ins: An Analysis of Initial Characteristics and Performance, CMBOR, 1991, and in K. Robbie, M. Wright and S. Thompson, 'Management Buy-ins in the UK', Omega, 1992;
Chapter 12- Initial factor and cluster analysis in C. Ennew, K. Robbie, M. Wright and S. Thompson, 'Management Buy-ins as a new Ownership Form: Entrepreneurial Characteristics and Performance', paper presented to the Babson conference at Fontainebleu, 1992 and reproduced in Frontiers of Entrepreneurship Research 1992, Babson College 1993; and forthcoming (August 1994) in International Journal of Small Business;
Chapter 14 and Appendices A7 to A12- Abbreviated case studies in M. Wright and K. Robbie (ed), The Economist Guide to Management Buy-outs 5th Edition, 1991;

I would also like to thank the directors (Mike Wright and Brian Chiplin) of the Centre for Management Buy-out Research for their help, support and co-operation over the past few years and to the financial sponsors of CMBOR, in particular those involved at an early stage of its development, Bob Willett and Adam Mills of Spicer and Pegler and Michael Cumming and Clive

McClintock of Barclays Development Capital. Comments on the original questionnaire design offered by Mike Wright, Steve Thompson, Gordon Murray, 'test' managers and various financial and professional advisers are gratefully acknowledged.

The help in the day to day administration of the Centre by various Administrators, most notably Margaret Burdett, is much appreciated and especially her help in typing the Tables and integrating them into the text. All the coding and entering of data for this survey are however my own work and responsibility.

Thanks also are due to Brian Chiplin as the Centre's Database Administrator for his re-design of the Centre's computer systems which has facilitated the analysis of this type of survey and to Chris Ennew for running a statistics analysis course for post graduates and for her subsequent advice on more advanced statistical treatment of the management buy-in survey.

Without the Buy-in Managers themselves this thesis would have been impossible. Thanks to those who responded to the questionnaire and especially to those who were prepared to go through detailed case study interviews. Thanks are also due to Clive McClintock and Alan Lewis for helping to pilot the questionnaire and to financing institutions for help over the years in identifying buy-ins and especially to Chris Biggs of 3i for liaison with 3i investee companies

Doing a thesis while also working full time has presented many pressures especially for my wife and children whose lives for the past few years have been dominated by thoughts of management buy-outs and buy-ins. To them I offer an immense "Thank You".

April 1993

CHAPTER 1

INTRODUCTION

1.1 Introduction

During the 1980's considerable changes occurred in the role of management in industrial ownership in the British economy. After moves in the 1970's to greater concentration of industrial ownership (Chiplin and Wright, 1980), the 1980's showed a different pattern with an increase in the number of companies being incorporated, a revival of flotations on the Stock Market including the newly created USM (Ingram 1985), increases in the sales of subsidiaries between companies and the emergence of transactions which involved management taking control of companies for which they had previously been salaried employees. Such changes reflected major political, cultural, structural, economic and other developments including the re-emergence of the Enterprise Culture (Bannock 1987, Burrows 1991). Part of this transformation was reflected in the revival of the Mergers and Acquisition market which reached a peak in 1989 but in a markedly different form from that in the 1960's and 1970's, paralleling developments in the U.S. In the 1960's acquisitions reflected unrelated diversification, but in the 1980's there were moves to consolidation and specialisation (Shleifer and Vishny 1991a) with a large minority of bids being hostile. These later transactions also included companies divesting subsidiaries to other corporate entities and in some cases to internal or external management groupings who were frequently seeking to acquire control in competition with other bidders.

This thesis focuses on an aspect of this last form of corporate restructuring, the management buy-in where external management gain executive control of a target company. It is the initial contention of this thesis that while buy-outs and buy-ins involve certain similar concepts within corporate restructuring, there are major differences between the two. The Thesis examines the nature of these differences in terms of motivation of both vendor and management, characteristics

of the target companies and the management teams, initial performance and actions and compares these with the longer established management buy-out, where incumbent management is the key.

1.2 Previous Research

Despite the existence now of a significant amount of research on aspects of restructuring, the relationship between restructuring and its consequences for the firm and its stakeholders is unclear. Restructuring may be seen as complex and multidimensional (Bowman and Singh 1993, Singh 1993). Management buy-outs and buy-ins may be considered to pose a complex set of issues related to corporate restructuring, the entrepreneurial nature of the managers involved, finance, the degree of post transaction restructuring and resultant effects on performance.

In the UK interest in management buy-outs started in the early 1980's (see eg Arnfield, Chiplin, Wright, Jarrett 1981) with an increasing flow of research output in both the US and UK by the end of the 1980's (see eg Palepu 1991, Wright, Thompson, Robbie, Wong (1992), Fox and Marcus 1992 for a review of the major studies). However cases where external management and their financial backers in the UK buy control of the company, the management buy-in, have yet to attract detailed research interest beyond professional journals (eg Shaw 1987, Hutchings 1987, Chatterjee 1988).

The relatively recent development of buy-outs in the UK has meant that research findings on their long term impact are only tentative (eg Houlden and Brooks 1989, Bannock 1990a, Wright Robbie, Starkey, Thompson 1994, Wright, Thompson, Robbie, Wong 1992), interest being orientated more towards aspects such as motivational factors, changes in strategy and the re-organisation which follows buy-out (Wright and Coyne 1985, Hanney 1986, Houlden 1990, Green and Berry 1991, Wright Thompson Robbie 1992).

In contrast the emergence of the leveraged buy-out market in the United States several years

before the UK buy-out and buy-in markets generated U.S. academic interest since the early 1980's (eg De Angelo et al 1984, Maupin, Bidwell and Ortregen 1984, Lowenstein 1985). Much of the early research focused on the rather narrow issues of the gains which are obtained at the time of the initial buy-out. Studies concentrated on the price announcement effects for leveraged buy-outs of quoted companies and issues relating to the ethical considerations involved in bids being made for quoted companies by their internal management and directors and the extent of possible abuse of management's inside knowledge. Indeed US research has until recently been concentrated on these 'going private' transactions rather than divestment buy-outs. Since 1989 there have been several studies of performance aspects of leveraged buy-outs in the US which go beyond concepts of gains to previous and new shareholders to examine aspects such as efficiency improvement, changes to R & D expenditure, spending on fixed assets and employment changes (eg Kaplan 1989, Lichtenberg & Siegel 1990, Singh 1990, Smith 1990) and more recently the longevity of buy-outs (eg Kaplan 1991). In the main, though not exclusively, these studies remain orientated towards going private transactions, in some cases examining buy-outs which have subsequently been floated on a stock market (eg Muscarella and Vetsuypens 1990).

Limited US attention has been paid to the entrepreneurial and motivational effects involved in smaller transactions (eg Bull 1989, Malone 1989, Taylor and Hooper 1989). There have been only a relatively small number of case study approaches despite their use in explaining pertinent factors behind changes in financial and accounting ratios (eg Baker and Wruck 1989, Magowan 1989, Bruner and Eades 1992). However, the act of corporate restructuring involves a complex interaction of forces relating to the need to restructure, the preferred mode of doing so, the availability of a suitable form for this to occur, motivation of both vendor and purchaser, financing considerations including sources of supply and relative roles of equity and debt, the role of operating and strategic actions in achieving operating efficiency improvements and the subsequent performance and implications of realisation strategies for the life cycle of the firm.

While much of the experience of the early and mid 1980's appears to support a highly favourable view of the characteristics of buy-out transactions and the benefits of the re-organisation which they entail, since 1989 this has not been so obvious: in both the US and the UK, buy-outs, especially those which are more highly leveraged, have suffered serious performance difficulties with a high incidence of bankruptcies (Kaplan, 1991, Fridon 1991, Chiplin, Wright, Robbie 1992).

Research has also been pursued in some other countries, eg France (Binz et al 1985, CEGOS 1990), Holland (Bruining 1992), Australia (Brookes 1992), Italy (Carulli 1991) and South Africa (Van Heerden 1992).

1.3 Development of Corporate Restructuring in the UK

The extent of corporate restructuring in the UK may be seen through examination of trends in the growth of the Mergers and Acquisitions Markets (Table 1.1). After growth in the 1960's the market reached a peak (in current prices) in 1972/73, fell back sharply in the mid 1970's but recovered towards the end of the 1970's. The 1980's proved to be a period of unparalleled restructuring with the value of mergers and acquisitions reaching a peak of £27.3 bn in 1989, although the volume high was in 1987 (1528 transactions). Considerable contraction occurred in 1990/1992.

Over the years the form of restructuring has changed. Until the early 1980's it typically had involved divestment of subsidiaries and divisions with the purchaser almost always being another corporate entity. In contrast the 1980's brought the role of management and their financial backers into greater prominence. Indeed, in 1991/92 over one half of all takeover transactions (by number) involved management participation (CMBOR, 1993). Comparisons can be made with the US where the take-over wave of the 1960's represented mainly friendly acquisitions in a major diversification strategy while those in the 1980's were much larger, frequently hostile and paid for in cash rather than stock (Shleifer & Vishny 1991a).

TABLE 1.1: ACQUISITIONS AND MERGERS BY INDUSTRIAL AND COMMERCIAL COMPANIES WITHIN THE UK, 1964-92

Year	Number Acquired	£Million
1964	940	505
1965	1,000	517
1966	807	500
1967	763	822
1968	946	1,946
1969	906	935
1969[1]	846	1,069
1970	793	1,122
1971	884	911
1972	1,210	2,532
1973	1,205	1,304
1974	504	508
1975	315	291
1976	353	448
1977	481	824
1978	567	1,140
1979	534	1,656
1980	469	1,475
1981	452	1,144
1982	463	2,206
1983	447	2,343
1984	568	5,474
1985	474	7,090
1986	842	15,370
1987	1,528	16,539
1988	1,499	22,839
1989	1,337	27,250
1990	779	8,329
1991	506	10,432
1992	433	5,940

Source: CSO
[1]Note: Series break in 1969

The desire to sell may be occasioned by many factors including financial distress, redefinition of core activities and acquisition through larger transactions of subsidiaries which may have no long term strategic rationale within the expanded group but could not be separated from the rest of the purchase agreement (eg Chiplin and Wright 1980, Ravenscraft and Scherer 1986). Although the need for companies to trade subsidiaries in this way is not in itself remarkable, the ability of individual managers in the 1980's to be an acquirer was more so.

Management's purchase of a company is dependent on a strategic and financial vision of the future of the firm which is sufficiently viable to attract financial backers. Equity financiers will expect to achieve significant targeted internal rates of return with banks providing debt finance on more modest lending margins against security. Other financial backers, including mezzanine players and the vendor, may be involved. Management through the ability of the backers to leverage the deal will put in a disproportionately small amount of finance for their relatively high equity stake in the company. All will expect to incur significant although varying degrees of risk;

The reduced agency costs (see 2.2 for definition and discussion) involved in such transactions may be expected to produce actions which make the company more efficient and through the debt bonding effect and managerial equity incentive the management shareholders are keen to create shareholder value rather than be overly influenced by desires to create large empires for the sake of them or indulge in wasteful company expenditure (Fama and Jensen 1983, Jensen 1989a). Such developments may be strengthened by management adopting a more entrepreneurial approach than had been possible under previous structuring (eg Bull 1989).

During the second half of the 1980's the UK management buy-out became an accepted part of corporate restructuring providing many opportunities for divestors, management and financiers (Wright, Thompson, Chiplin, Robbie 1991). This process was accelerated by rapid increases in funding committed to buy-outs, evidence of successful investor realisation within relatively short

time periods of some of the early buy-outs and fiscal reform. As the buy-out market became more mature, deal sizes became larger and near the top of the stock market and mergers and acquisitions market cycles, buy-outs became more orientated towards financial engineering. Many company managers were in positions where a buy-out was not feasible, but wanted to become owner managers; divestors were not always willing to sell to management; and financing institutions, given the influx of new entrants to the market, were keen to expand into areas where traditional principles associated with venture capital could be applied but where projected rates of return were higher than in buy-outs (Chatterjee 1988, Shaw 1987). Additionally concerns were expressed by divestors and City institutions as to the possible extent of the 'insider' role of incumbent management leading to company under-valuation especially in going privates (NAPF 1989), echoing concerns in the United States (eg Bruner and Paine 1988, Schadler and Karns, 1990).

The development of the management buy-in, which involves external rather than incumbent management gaining control of the company with the support of specialist financiers, can be seen as a proactive response by certain venture capitalists to these factors (eg Hutchings 1987). Management buy-ins were seen initially as a way by which the entrepreneurial talents of good managers and of entrepreneurs who had been previously backed but sold their business could be applied to opportunities where a buy-out was not possible (Batchelor 1987). They could satisfy growing concerns felt about the privileged information which managers possess, provide stronger management for turnaround situations and would involve financiers in providing additional skills to those seen in normal buy-outs increasing their ability to generate fees in the short term and, if successful, a higher rate of return in the medium and long term (eg Hutchings 1987, Shaw 1987). They would be particularly suitable in cases where the company had been under-performing under existing management and turnaround was required. This type of manager may also be able to grow companies more successfully than in management buy-outs where management despite their proven competence may not have the same degree of vision. While managers buying in had

much to gain, it was a riskier venture than a buy-out, where management had intimate knowledge of the company and its position. As in management buy-outs, equity ownership incentives and debt bonding could be expected to be a major influence on subsequent performance. Additionally the concept of the buy-in could be applied to the quoted company without the particular ethical concerns applicable to buy-outs by incumbent directors.

The buy-in market grew rapidly in the late 1980's, its peak in 1989 of 148 transactions worth £3.6bn accounting for 48.2 percent of the total UK buy-out market by value (see Chapter 5.2 for detailed examination of trends in buy-ins) but coinciding with the start of the downturn in economic activity and the early stages of a period of high interest rates (Robbie and Wright 1992b). After significant restructuring and bankruptcy of many existing buy-ins and changed institutional attitudes, growth of private buy-ins resumed in the autumn of 1991 (Chiplin, Wright, Robbie 1992). Analysis of early buy-in performance and their restructuring characteristics is therefore inevitably influenced by general economic and financial factors which make earlier studies of UK buy-outs, mostly carried out in a period of economic expansion, not strictly comparable.

1.4 Identification of Differences Between Management Buy-in and Buy-outs

Management buy-outs and buy-ins may be expected, while both involving management teams taking a significant equity stake in a company alongside specialist external equity investors with relatively high degrees of leverage also necessary to complete funding, to have major differences in characteristics, produce different performance effects and incorporate several different theoretical concepts. Justification for buy-outs comes from a combination of agency cost and entrepreneurship theories (Bull 1989, Wright Thompson Robbie 1992), both of which are considered applicable, but in different ways, to management buy-ins. In buy-ins considerable emphasis is placed on the role of external management in target company re-organisation with the introduction of the concepts of the role of new management in initiating necessary change,

applying new strategies and thereby helping to effect turnaround from a frequently declining position. Management buy-ins may therefore be able to form an effective restructuring method in companies where the narrower buy-out concept may be unlikely to be successful as the existing management team may be lacking in entrepreneurial skills and not capable of producing the type of performance improvements required. Management buy-ins may also result in a contested and possibly hostile bid should incumbent management or another company be interested in acquiring the target. In so doing they may enhance the market for corporate control as managers compete for the right to manage the corporate assets.

The probable success or failure of the buy-in may be influenced by factors concerning the target company; the new management's entrepreneurial and other characteristics; the role of the financier and the mix of financing supplied; the choice of restructuring strategies; and the longer term aims for company, management and financier. These are discussed below.

Factors concerning the target company include the reasons for sale or divestment in the first place, the state of the business concerned in terms of size, profitability, company and industry growth prospects, price, competition between potential purchasers including buy-out teams and cash requirements and the type of previous ownership. The way the company has been run before (eg the potential contrast between the systems orientated control in the subsidiary of a multinational with a privately owned company where the founder entrepreneur dominates all decision making and pays minimum attention to accounting considerations) may well influence the extent of initial problems found by the new management team.

Management themselves may come from a combination of educational, managerial and professional backgrounds (3i, 1992a). These may range from MBAs working in the Head Office of major quoted companies through professionally qualified managers who could have been in either quoted or privately owned companies to people with few qualifications but have been

successful through their deployment of entrepreneurial talent. Additionally there are former owner-managers ranging from members of former buy-out teams to entrepreneurs who established their own companies, who have subsequently sold out and found a fresh challenge in a buy-in. The adaptability of these various backgrounds to particular buy-in situations will vary. The transferability of skills to a different company, sometimes in different regions or even sectors may not always be successful. Teams may be motivated in different ways from those in buy-outs. In addition to the personal, managerial and entrepreneurial strengths of these management entrepreneurs is the need to be able to work with like-minded people as part of a cohesive team.

The role of advisers and especially financiers will be critical to the successful future of the company. Managers buying in face an asymmetry of information which buy-out managers do not have. Consequently the role of Due Diligence, the process through which key financial factors such as accuracy of accounts, valuation of assets is checked, is especially important. The structuring of finance must also reflect the higher risk this information asymmetry implies as well as ensuring funds are available for expansion. Managers require to be suitably incentivised through their equity holding and to continue to have sufficient incentives even when performance targets may have been missed. At the same time the role of the providers of debt will also be crucial. The system of governance will be considerably different from traditional models. Both debt and equity financiers, through the imposition of covenants and Shareholders Agreements, will have the ability to monitor and control the company in a particularly active way making major contributions to the direction and success of the company.

The success of the buy-in will depend not only on the entrepreneur's characteristics and the financial background to the transaction. The actions taken by the Team will prove critical in turning an under-performing company into a good performer. While the pressure of debt on management and the incentive of managerial equity will clearly be important influences, the correct balance and application of operating and strategic actions will be essential.

A further important aspect concerns the longer term aims for the company, management and financiers and especially whether buy-ins are permanent or transitory forms in terms of the company life cycle. Like management buy-outs, the management team and their venture capital backers are likely to have plans for eventual realisation of their share holdings (Lorenz 1989) although the method and timing may differ significantly from original intentions (see eg Wright, Robbie, Thompson, Starkey 1992). However in the case of management buy-ins, increased risk compared to buy-outs can be seen through the information asymmetries concerning the company as well as the nature of the turnaround action which may be required. The higher risk perceived in the transaction and reflected in the financial structuring of the management buy-in will have implications for the expected period of investment and the method of control employed by the venture capitalist to achieve it.

1.5 Structure of the Thesis

This thesis aims to scrutinise the role the management buy-in has to play in corporate restructuring and the ways in which buy-ins differ from buy-outs. The concept contributes to an understanding of the corporate restructuring process by examining a new and alternative form of transfer of ownership with important interactions with the role of the entrepreneur, the strategy required to turnaround under-performing companies, the role of networks in identifying and completing ventures, the effects of changes in Chief Executives on a company and the life cycle of firms. The thesis explains the differences between the buy-in and the buy-out and the essential characteristics of the Team, the target company, the buy-in process and the organisational and performance benefits which can be expected to come from a buy-in. In so doing the thesis critically reviews the impact of general corporate restructuring concepts, the role of the entrepreneur, finance, methods of restructuring action and evidence of longer term performance and life cycle aspects. The thesis also develops a typology of the buy-in Team leader and identifies important differences in characteristics both between the types of leader identified and those of management buy-outs. These differences are then extended to identify links between performance

and types of Team Leaders.

The thesis starts in Chapter 2.1 by developing a model of the management buy-in process which serves to highlight the issues involved in management buy-in transactions: these include the formation and composition of the Team, the restructuring opportunity, team and vendor motivation, search and identification of a target company, the existence of appropriate infrastructure for transactions to occur, aspects of deal completion including financial structuring, and post transaction issues including performance, governance, actions and the life cycle of the company. The relevance of these main areas is explained and literature critically appraised.

Examination is first made of the types of restructuring forms which have evolved during the 1980's, the development of buy-outs and the role of buy-ins within the general family of corporate restructuring forms (2.2.2). Attention is paid to the distinctions which can be made in terms of the different sources of transactions (2.2.3). Moreover, whilst buy-ins share certain common characteristics with each other, the management buy-in concept is not homogeneous. The characteristics of buy-ins will differ enormously ranging from the highly leveraged transaction of a large quoted company such as in the cases of the LBOs of Gateway by Isosceles or DRG by Pembridge Investments to the smaller buy-ins of less than £1 mn involving activities which were formerly parts of privately owned companies (see for instance cases in Chapter 14 and Appendices 7-12).

Consideration is then given to the vendor's motivation in selling to management (2.2.4) and how the decision to divest can be partially seen as a reaction to issues associated with multi-divisional firm organisation and Agency Cost considerations (2.2.5). While a vendor may seek to sell a subsidiary or company for a variety of reasons (eg strategic re-direction, under-performance, financial distress of either the subsidiary or parent, unwanted part of an earlier acquisition), the actual choice of purchaser will depend on various factors. In some cases buy-ins may produce

particular advantages over buy-outs, eg the credibility of management to implement a recovery strategy to preserve employment. One of the main considerations in acquiring the target company is likely to have been the belief that under its previous ownership and management it was under-performing relative to its competitors. Chapter 2.2.6 analyses the strategic and managerial aspects of turning round a target company, assessing the literature on corporate under-performance and turnaround actions.

As a result of the different circumstances surrounding management buy-ins compared to buy-outs, the managers involved in buy-ins may be expected to possess entrepreneurial characteristics which show certain distinctions from those of Team Leaders in other types of venture capital transactions and are also separable from those typically displayed by managers who are not owners. Chapter 2.3 provides an initial examination of the Team Leader and Team including consideration of the role of the Entrepreneur (2.3.1). The development of entrepreneurial characteristics, however, have been seen to derive from a complex of issues: personal backgrounds including age, education, culture and religion (2.3.2), the relevance of previous entrepreneurial experience (2.3.3), and psychological and motivational aspects including the Entrepreneur's need for achievement, risk taking capacity and the influence of displacement effects (2.3.4). The relevance and development of entrepreneurial typologies is also assessed (2.3.5).

Another important element in the buy-in process is ensuring that an appropriate infrastructure exists for the generation of transactions and completion of opportunities. The desire of Teams to buy a company must be matched by a willingness of the vendor to sell and the presence of an appropriate financial, legal and taxation system to complete the transaction. Relevant general factors are described in 2.4.1 with particular emphasis on the role which the Team Leader's incubator organisation may have (2.4.2). Entrepreneurs are likely to employ a combination of both formal and informal networks (2.4.3) to identify and complete the transaction. While much of the identification process may be done using existing informal networks, final negotiations and

completion will involve advice from accountants and the use of venture capitalists (2.4.4). There will be a clear trade-off between the desire of the venture capitalist to be involved in this type of transaction and the business acumen skills, abilities and experience of the buy-in team members. The accounting adviser may play an important part, assisting the entrepreneur in his search for venture capital and helping to originate the venture capital proposal. An important element of the venture capital process will be due diligence procedures.

Completion of the transaction (2.5) involves a range of issues including financial structuring (2.5.1) and a pricing which ensures fair value for the vendor (2.5.2). Corporate restructuring as well as creating suitable forms for changes in ownership structure may also be expected to create wider managerial and employee share ownership and produce incentives towards significant improvement in the operating performance of the target company. By giving the new management (and in some cases a wider band of incumbent managers and employees) the opportunity to acquire an equity stake, significant incentives are created which may be expected to improve the performance of the company. These may be enhanced by the use of equity ratchets. In addition by using higher degrees of leverage than conventionally employed in UK corporate finance, management in both buy-ins and buy-outs enter a different style of contract with financiers designed to reduce the agency costs of transactions and give incentives from equity ownership but also creating a bonding factor through the commitment to service debt. Clearly the degree of leverage has to be finely tuned to the individual transaction- allowing gains in operating efficiency not only to be achieved in the short term but to allow for the appropriate structures for these gains to be retained in the longer term for the success of the buy-in. Completion also involves issues concerning the pricing of the transaction and ensuring that the selling shareholders (2.5.2) achieve a fair value for the assets disposed. Consideration is given to the possibility of the misuse by management in buy-outs of insider information in the deal negotiation process.

Chapter 2.6 critically reviews post transaction issues starting with an examination of the issues

relevant to performance (2.6.1) before presenting existing evidence on buy-out performance (2.6.2). As explained in Chapter 1.2, the short time period which has elapsed since buy-outs became common has meant that few large sample, long term performance studies have been completed. For buy-ins there are none except studies of United States LBOs, which, despite their similarities, do differ significantly in some major respects (eg degree of leverage, initiation of transaction, average size) from the private buy-ins which are the subject of this thesis. Nevertheless there are implications for UK buy-ins from these US studies in respect of both the anticipated beneficial and negative aspects which could accompany such transactions. Turnaround action is examined in 2.6.3 and the role of new management in achieving performance improvements assessed in 2.6.4.

The type of control exercised by the financier and the methods of finance used are crucial to the buy-in transaction and a distinct form of corporate governance is introduced (2.6.5). Shareholders Agreements and Articles of Association will state the framework for a new system of Governance which will include tight monitoring systems, controls on certain major developments (eg capital expenditure, divestments, acquisitions) as well as right of equity investors to Board of Directors representation. The shorter chain of command between shareholder and company than in the conventional subsidiary of a quoted company status allows more flexibility of action and the ability to counter adverse trends or take advantage of opportunities at an early stage. The new system of governance is appraised in 2.6.5. To help attain expected financial and operating efficiency improvements, management and institutions may introduce more appropriate accounting and reporting systems.

There are additionally longer term aspects concerning the period for which the company remains independent and whether there is the possibility of a consistent life cycle theory approach (2.6.6). Development of the buy-in's business may imply different long-term ownership forms which require to be made consistent with the aims of both management and the venture capital

investors. The latter will, in general, seek realisation of their investment in the medium term by several methods. The extent to which a financial engineering approach by certain institutions and advisers in the late 1980's affected the development of the market and imposed a degree of short-termism rather than long term support for an independent company is also relevant. The buy-out funds which dominated the medium and large end of the buy-in and buy-out market in the late 1980's frequently worked on comparatively short life cycles themselves requiring investments in the companies to be realised at a relatively early stage so that capital gains could be accrued for the investors in the funds (Robbie and Wright 1992a, Wright, Robbie, Thompson, Starkey 1994).

Issues discussed in Chapter 2 have tended to reflect buy-out experience in that there has been no other published academic literature specifically on UK management buy-ins. Issues raised are applied to management buy-ins in Chapter 3 through a model of factors influencing management buy-ins which provides a synthesis of the various strands of theory which are considered relevant: entrepreneurial influences (3.2), vendor motivation (3.3), the target company (3.4), search and identification (3.5), deal completion (3.6) and post transaction issues (3.7). In this Chapter the distinctive form of management buy-in is highlighted. As well as possessing the known advantages of buy-outs derived from corporate restructuring and entrepreneurship theories, buy-ins may be seen to have particular applications. Similarities and differences between buy-outs and buy-ins in general are identified through examination of management, personal background and motivational aspects of the Team, company characteristics and financial aspects. This leads to the statement of the main hypotheses and propositions of the thesis.

The remainder of the thesis presents empirical work covering management buy-ins in general which has been obtained through the establishment by the author of a database on over 750 UK management buy-ins, a questionnaire survey of buy-in Team Leaders and case study interviews carried out with buy-in Teams at their companies. The methodology employed is explained in Chapter 4.

In order to describe the context of the development of the buy-in market, Chapter 5 discusses the growth in the UK of buy-ins in general and their basic characteristics, making comparisons where possible with buy-outs and testing for significant differences. Buy-ins may have different sectoral, size and regional characteristics while risk factors may have resulted in financing structures and realisation methods which are significantly different from those in management buy-outs.

Chapters 6 to 11 use descriptive statistics from the buy-in questionnaire survey to test entrepreneurial, motivational, network, strategic, restructuring, performance and life cycle issues raised in the earlier literature review. This analysis commences with the backgrounds of managers who have bought in, initially investigating the personal and educational background of the buy-in Team in an attempt to look for characteristics which tie in with conventional entrepreneurial theory (Chapter 6). The presence of specific background features such as parents who were owner managers of enterprises, the age at which the entrepreneurial decision was made and educational background may all have an impact (6.2). Patterns of career development may also be relevant (6.3). Some managers may also have had previous experience of being owner managers either through a new venture or through being part of a buy-out (6.4). Additionally the composition of the team and the possibility of a skills gap could be important for subsequent cohesiveness of the Team and successful target performance (6.5).

Chapter 7 considers questions relating to the motivations involved in the buy-in: these issues have to be seen in terms of both the Team (7.2) and the vendor (7.3). In the case of the latter consideration is also given as to why a management buy-in Team should be the preferred purchaser.

The need to identify a suitable target company, ascertain that the company is for sale and to go through financial, accounting and legal processes is essential to ensure completion of the buy-in. The potential Manager-owners may use a variety of search methods, some of which may be seen

to rely on informal and others on formal networks. Issues relating to these are discussed in Chapter 8. Within this there are important questions discussed concerning the differences and similarities between the buy-in target and the Team Leader's incubator as well as the importance of networks in identifying or helping in establishing the buy-in (8.3). Furthermore the characteristics of the target company provide some evidence as to whether buy-ins reflect general perceptions of buy-outs being in cash generative, mature industries. Buy-ins may also be seen by Teams during their search to provide attractive turnarounds or to be suitable vehicles for a series of corporate acquisitions (8.4).

Methods of financial structuring are clearly extremely important in terms of the gains which can be expected from the corporate restructuring process and Chapter 9 examines the way in which the buy-in sample have been financed. The role of equity and debt in making management perform is clearly critical through bonding management to servicing financing instruments but at the same time giving them the necessary incentive for personal financial gain. There is also the question as to how widely the new management are prepared to spread the equity ownership to incumbent management. As part of the new Governance finance will have been accompanied by a large number of conditions: whilst these will have been seen by the banks and venture capitalists as necessary for completion of the transaction, they may be seen by management as restrictive and unnecessary (9.4). This Chapter considers these conditions and their effects on institutional relations.

The success of the buy-in will depend on the effectiveness of the actions taken by the new management (and the institution's monitoring and control) both in the areas of redefining the aims of the company including new investment, the reform of marketing, sales, financial and production systems and practices, making acquisitions and introducing management changes and incentive systems (Chapter 10). Specific comparisons testing for significant differences are made with earlier studies of management buy-outs, sharpbenders, turnarounds and new ventures (10.6).

Some insight into performance can be gained from the results of the survey questionnaire although the relatively short period since the buy-ins were completed and lack of accounting data means that only an examination of general trend effects is possible (Chapter 11). Evidence of direction of performance is linked to relevant variables relating to the background qualities of the management, the company and the buy-in structuring (11.2) as well as placing performance in an overall economic and financial context. Problems which emerge post buy-in are identified (11.3) and finance requirements examined (11.4). Realisation intentions and actual exits by the buy-in sample are discussed (11.5).

Entrepreneurship theory has developed typologies of entrepreneurs. These are typically classified into two main groupings - opportunists and craftsmen and have been tested principally in the US although there have been two major European studies (see Chapter 2.3.5). Using factor and cluster analysis Chapter 12 examines motivational and certain background demographic features of Team Leaders to develop a typology of UK Buy-in Team Leaders. The types identified are then examined for their closeness to classifications of entrepreneurs described in other studies as well as Buy-out Team Leaders. The possibilities for the existence of differing performance characteristics between the various types of Buy-in Team Leader 'clusters' (12.4) as well as between Buy-out and Buy-in clusters (12.6) are also examined.

A fuller analysis in made in Chapter 13 of performance determinants. Employing discriminant analysis on a measure of performance, major variables identified earlier in the Thesis as likely to affect the performance of buy-ins and representing a range of entrepreneurial, personal background and company characteristics and aspects of financial structuring are used in a stepwise sequence.

Chapter 14 analyses case study interviews in terms of the management buy-in process and the issues which emerged in the literature survey and the empirical evidence from the questionnaire

survey. A model of the buy-in process is developed to provide a suitable background framework for this examination. This synthesis of case study issues allows an analytical approach to be made extending discussion of the issues arising which include consideration of the types of backgrounds of buy-in managers; the methods of identification of the target company; modes of approach to institutions; due diligence; financing structures; problems which emerged on buy-in and consequent re-organisation; factors influencing initial performance; the influence of debt bonding and equity incentives; the new style of corporate governance; realisation and the life cycle of the target company. The variety of cases covered represented the diversity of backgrounds in buy-ins and corporate restructuring: these cover buy-ins from privately owned companies including a management buy-out, divestment from both a UK controlled quoted company and an overseas owned company and a buy-in leading to a going private of a stock market quoted company.

Chapter 15 presents the conclusions of the thesis appraising the differences between management buy-outs and buy-ins and discussing the salient issues. The Chapter contains implications for policy makers, providers of capital and potential management buy-in teams as well as recommendations for further research. This is followed by Appendices which include copies of the survey questionnaire, forms used to gather more general information on buy-ins, the names of the companies participating in the survey and detailed case studies.

CHAPTER 2

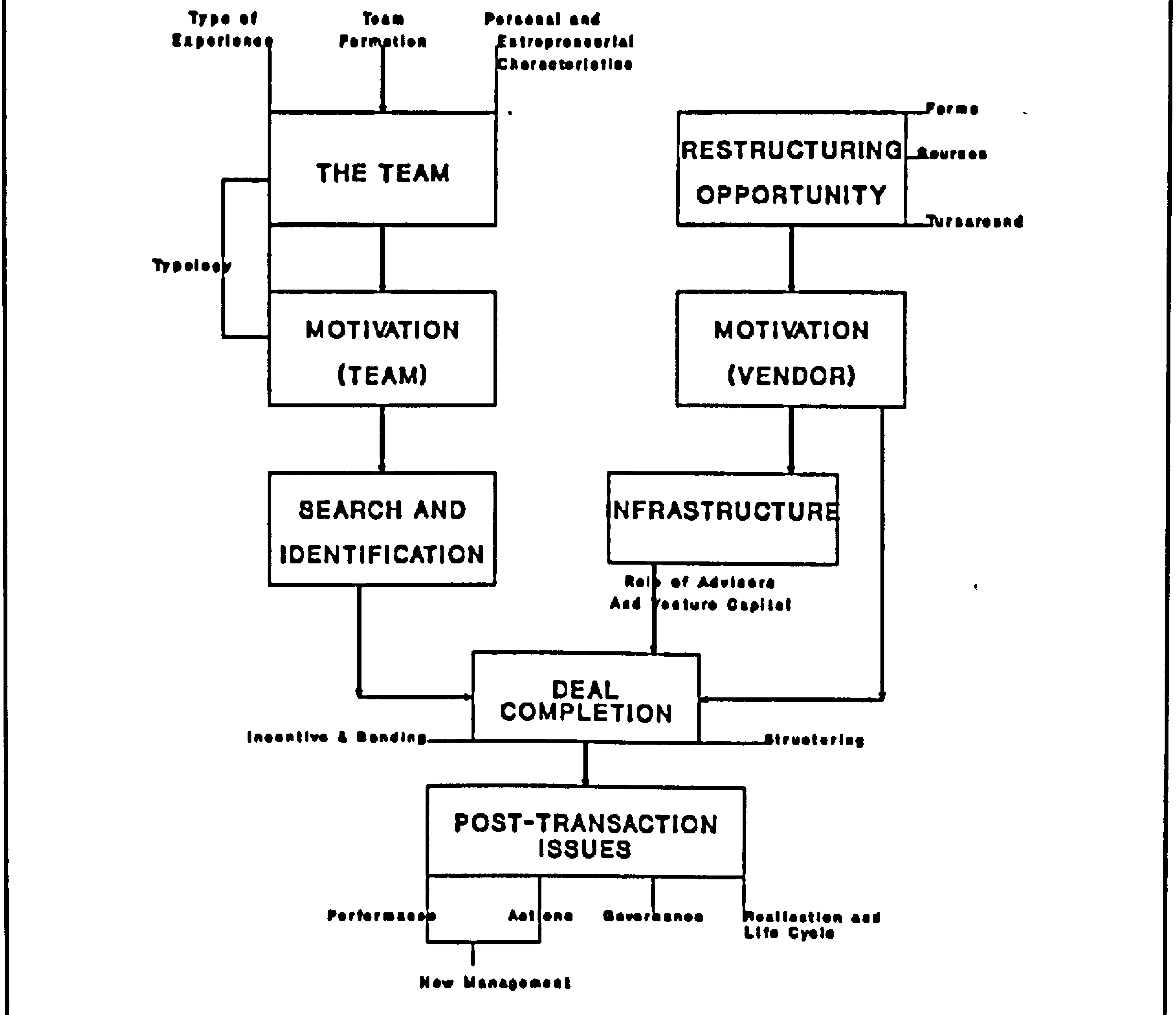
ISSUES INVOLVED IN MANAGEMENT BUY-OUTS AND BUY-INS

2.1 Introduction

Chapter 1 described the outline of the Thesis and the importance of management buy-ins within corporate restructuring. This Chapter explores the issues which are relevant to the management buy-in process thereby paving the way in Chapter 3 for the raising of various propositions and hypotheses concerning management buy-ins and their differences with management buy-outs and other forms of venture.

For expositional purposes, the issues involved in management buy-ins can be structured in terms of the management buy-in process (Figure 2.1). Key to the achievement of a buy-in is the matching of an appropriate Team to a Target Company. This means that a corporate restructuring opportunity must be seen to exist and that the potential vendor must be willing or be persuaded to sell- ie there is a corporate restructuring opportunity to be exploited. The need for such restructuring and the vendor's motivation are important issues and lead to an examination of types of ownership and forms of restructuring which may be relevant. A major reason for restructuring is seen as poor performance leading to consideration of issues relating to turnaround of poor performers.

Within the Team there are issues concerning the type of experience of the members, how the team is formed and their personal and entrepreneurial characteristics. Entrepreneurship literature has pointed to the importance of certain personal characteristics such as age, education, parents, cultural and religious influences while previous experience of business ownership- either by themselves or their parents- may also be relevant. The motivation of the Team is a key factor and the extent to which there is a clear need for achievement, the entrepreneurs are prepared to



engage in risk taking or whether they have been displaced from a previous venture or employment. Recent entrepreneurship literature has also pointed to the possibilities of entrepreneurs being classified into certain typologies and there is the question as to how management buy-in Teams may fit into these more general approaches.

The matching of the vendor with the buyer relies on the existence of an appropriate infrastructure for the transaction to take place. Within this there are issues concerning the type of company which the Team are searching and how it can be identified. This includes for instance the role of

incubators and networks. Key issues will be the role of professional advisers such as accountants as well as the presence of venture capitalists.

Assuming that the deal is completed, issues arise as to the structuring of the transaction and especially financial aspects. The need for corporate restructuring has been frequently seen to derive form a need to reduce agency costs, provide more equity incentives, more debt bonding and control by shareholders including direct control, by executive management. The way in which bonding and incentive issues can be incorporated into financing structures requires examination.

After the completion of the transaction there are however more long term issues which require to be examined. These include the way in which performance of the target company can be expected to improve and the influence of turnaround strategies and actions. The role of new management as opposed to the case of buy-outs where existing management continues is highly relevant. Longer term issues are also important in terms of whether a realisation is sought by the investors in the short or medium terms or whether a long term approach is used. The way in which this may be achieved has relevance also for governance issues.

The Chapter proceeds by examining the main issues illustrated in Figure 2.1 as follows: the corporate restructuring opportunity (2.2), the Team Leader and the Team (2.3), Infrastructure Aspects (2.4), Deal Completion (2.5) and Post Transaction Issues (2.6).

2.2 The Restructuring Opportunity

2.2.1 Introduction

As described in Chapter 1, from about 1980 in the United Kingdom the ability of management (supported by specialist financing institutions) to purchase a set of business activities which they had previously been managing has produced major alternatives to traditional acquisitions in the

form of management buy-outs. This development came after the emergence of Leveraged Buy-outs in the US which usually involved external management and frequently that of the specialist financing institution. These developments were followed in the UK in the mid-1980's by venture and development capital backed external management acquiring target companies, the management buy-in (Robbie 1988). While in the UK the vast majority of buy-out transactions have been of firms which have not been listed in the stock market or have been subsidiaries of listed firms, in the United States an extremely important variation has been the 'going private', whereby institutions have backed incumbent management or provided their own management to purchase the company and de-list it from the stock market, although in some cases refloating it several years later and frequently using high degrees of leverage. By 1987 one third of the US market for corporate control was in the form of LBOs (Hall 1989) and by 1991 over half the number of corporate control transactions in the UK were in the form of management buy-outs and buy-ins (Chiplin, Wright, Robbie 1992).

Corporate restructuring may be seen as having three main inter-related strands- the re-organisation of activities between and within firms; a greater link between equity ownership and decision-making and a shift in financial structures involving more leverage as well as changes in control for equity holders. Before examining the issues involved in deciding to restructure, the various forms of restructuring are described.

2.2.2 Types of restructuring

Corporate Restructuring may be initiated by a single interest or by a combination with management having a variable level of control in the new entity. The major parties involved are: financing institutions, management, LBO partnerships, vendors and consortium. The range of forms of buy-out and the relevant initiators are shown in Table 2.1.

TABLE 2.1: INITIATORS AND TYPES OF CORPORATE RESTRUCTURING INVOLVING BUY-OUT AND BUY-INS		
Type of Restructuring	Initiator	New Owner(s)
1. LBO	LBO Partnership	(1) LBO Partnership and backers (2) Management
2. MBO Large MBO	(1) Management (1) Institutions (2) Management (3) Employees	(1) Management (2) Institutions (1) Institutions (2) Management (3) ESOP
3. MBI	(1) Institutions (2) External Management	(1) Management external (2) Institutions
4. BIMBO	(1) Institutions (2) External Management (3) Internal Management	(1) Institutions (2) Old + New Management
5. Spin-off	(1) Vendor	(1) Vendor (2) Management (3) Institutional
6. Going Private	(1) Management/Institutional (2) Consortium	(1) Management/Institutional (2) Consortium
7. Public MBI	(1) External Management (2) Institutions	(1) Management external (2) Institutions

The traditional UK **management buy-out** involves the transfer of ownership of an entity from its current owners to a new set of shareholders in which the existing management are a significant element. In the most clear cut case, a management team comprising the senior staff covering the line functions of the business will have a majority or even total stake in the equity of the newly independent firm, the remainder of the funding being provided by financial institutions in the form of a mixture of debt and equity. In small buy-outs the management team may have a majority of the equity but for the larger transactions the majority is likely to be held by a syndicate of institutions (Chiplin, Wright, Robbie 1992).

The proportion of shares held by management and employees may frequently depend upon the medium term performance of the firm and may be adjusted up (and sometimes down) by means

of a ratchet mechanism (Thompson, Wright 1991). In large buy-outs, it may permit a majority equity stake to be obtained if performance targets are met. The reasons for the use of such techniques are varied but concern the need to motivate management to perform at levels which allow institutions to achieve target rates of return, and resolve conflicts between institutions and management as to the latter's appropriate equity stake.

In transfers of ownership involving large firms, or where managers below the senior level are key to ensuring the targets needed to service a highly leveraged financial structure are met, equity participation may be extended beyond the core team of managers. Occasionally, all employees may be offered the opportunity to purchase equity, without there being an obligation to invest, producing an employee buy-out. Another option is through the establishment of an **Employee Share Ownership Plan or Trust** (ESOP, ESOT) which is effected by the establishment of a trust (Brennan 1990). The trust may borrow to buy shares on behalf of the employees. This type of scheme offers a more widespread ownership of shares, although employees as a body will tend to hold a minority stake. It is unusual, in practice, for all employees to take up their opportunity to own shares, let alone for there to be an even distribution of the size of holding across the firm. However, schemes can be constructed to permit this pattern of ownership.

In contrast to management and employee buy-outs the **Management Buy-In** can be broadly defined as the transfer of ownership whereby management control of an existing business is gained by a manager or group of managers who have not been working for the company before and who have not necessarily worked together before. This management control will have been obtained through the acquisition of a significant equity stake in the company concerned. The transaction will normally involve the purchase of equity in the target company not only by the new management but also by the buy-in team's financial backer. Management buy-in teams need to be seen as distinct from corporate acquisitions or reverse takeovers where it is the company rather than the management taking the risk. The necessary degree of management control post

acquisition to constitute a management buy-in varies: it is however essential that the overall equity held by the parties involved should be the dominant shareholding group and the new management have effective managerial control. This may imply an equity percentage in a range from as low as ten percent to as high as 100 percent.

Buy-ins may be further divided into two main categories: **private buy-ins**, ie those that occur exclusively in private companies or through the divestment of parts of larger or quoted or overseas companies; and **public buy-ins** where companies which are quoted on the Stock Market are the target. Private management buy-ins reported on in this thesis exclude purchases of businesses by private individuals which can be financed entirely through their own equity and commercial bank finance unless they are of a substantial size, taken to be over £1 mn. The normal buy-in transaction reported on here will involve venture/development capital institutions backing a new management team, although other private or public providers of equity may also be involved. The public buy-in refers to the management take-over of a quoted company. In come cases wealthy private investors have been able to arrange this without financial support of merchant banks, but in the more general case the new management act with financial backers. In many ways this is similar to the US Leveraged Buy-out involving external management groups with specialist equity backers frequently using leveraged financial structures.

There is an increasingly grey area where a combination of external and internal management join to form the new team. In some cases the team may include former members of staff of the target company. The hybrid form may be referred to as a BIMBO (Buy-in/management buy-out) (3i 1992a). What is important in distinguishing between these hybrid forms is from where the original initiative for the transfer of ownership came. buy-out transactions in the US. There the term MBO usually refers to buy-outs of companies quoted on the stock market which subsequently cease to be listed and where management have a significant equity stake, the **'Going Private'**. The US **Leveraged Buy-out** (LBO) usually involves a specialist deal-maker or LBO partnership, who

negotiate the deal, and directly and indirectly supply equity and debt finance; this represents more a highly geared version of the UK MBI rather than the UK MBO. Typically, a small amount of equity is put forward with substantial amounts of debt being used to fund the major portion of the purchase price. After the LBO is complete, new senior management, often employees and equity holders of the LBO partnership, are likely to play a key role in the running of the business and ensuring it meets its debt repayment targets. Incumbent management may or may not receive an equity stake.

In some buy-outs and buy-ins, vendors may wish to place executive control of an entity at arm's length whilst retaining a minority stake. The retention of some element of ownership serves several purposes- it helps the vendor participate in future gains and possibly avoid some of the problems of selling at a price which subsequently appears to be too low; it permits continued influence where trading relationships remain; and it may be key to actually effecting the transfer of ownership where it fills a funding gap and may make the buy-out credible as an independent entity in the eyes of its suppliers and customers (CMBOR/NAO, 1991). Where the vendor retains a majority stake the terms **spin-off** and **corporate venturing** may be appropriate. This form of organisation, which provides management with an equity incentive and the freedom to develop the business has so far been little used in the UK, though it is quite common in the US (Garvin, 1983). The alternative to these routes has traditionally been for entrepreneurial management to leave the incubator environment of the parent and establish an entirely new firm (Johnson and Cathcart, 1979).

A **joint bid** with an existing firm may be appropriate where incumbent employees, though possessing important skills necessary for the business to survive, are unable to raise sufficient funds to acquire the entity on their own against competing bidders and where market conditions are such that extra resources are needed for viability.

2.2.3 Sources of Transaction for Buy-outs and Buy-ins

Concern as to the performance of firms in dynamic market environments has led to the possibilities for corporate restructuring in both private and public sectors. In the former in the mid and late 1980s the volume and value of takeover activity in the UK rose dramatically and included acquisitions of very large firms as well as sales of large subsidiaries or divisions to other groups checking a long period of increasing aggregate concentration in UK industry (Department of Enterprise 1988). In the public sector significant restructuring also occurred with government ownership of assets seriously questioned (Vickers and Yarrow, 1988).

The most important source of buy-outs in the UK has been divestment, first as parent groups sought to restructure by disposing of unwanted, peripheral, poorly performing subsidiaries, and later as parents sought to shift their core activities. Such shifts were often out of areas of failed earlier diversification attempts. In a smaller but significant number of cases important trading relationships remained between the former parent and the buy-out/in. In these ways corporations were able to effect restructuring and metamorphose themselves into entities which enhanced shareholder value.

The relative position of divestment declined throughout the 1980s (although their absolute numbers increased) as buy-outs involving whole firms, privately owned firms and companies quoted on a stock market, became more important. The last have been most closely associated with highly leveraged US corporate restructurings, where quoted firms or very large divestments has often been associated with subsequent divestment or unbundling activity to refocus the spread of a firm's activities. Importantly, this divestment may also be key to reducing what are initially very high debt levels to amounts which can be serviced comfortably from normal cash flow. In the UK, the bust-up approach to buy-outs has generally been limited and below levels seen in the US (Chiplin, Wright, Robbie, 1990). In principle buy-ins also have an important role to play in

meeting these divestment opportunities although they have been relatively less important as an overall source than for buy-outs.

A common theme in several continental European countries has been the use of buy-outs and buy-ins to effect succession in often large family-owned businesses ensuring that independence is retained (Robbie, Wright, 1991). In France specific government legislation was introduced through the RES scheme to encourage such transfers of ownership to management (Heuze 1990). In other countries such as Italy and Spain a problem in succession has been the likelihood that the forceful and successful entrepreneur may not have an adequate Deputy to be able to gain institutional support for a buy-out. In such circumstances the management buy-in can play a more important role in corporate restructuring than in the UK.

Some divestments by foreign-owned firms restructuring to concentrate on their home markets have also provided scope for buy-outs. In countries such as Germany, Italy and Spain where accurate accounting information and management systems are significantly different from the UK, the management buy-out may be more appealing to the institution than a transaction involving a local divestor: the likelihood is that the accounting and reporting systems as part of an international group will allow more effective due diligence to be performed. Additionally management may be of a more internationally acceptable calibre. At the same time, such companies may through the acceptability of information standards provide suitable opportunities for management buy-ins.

Buy-outs from the stock market, 'going privates' have been a major element of the US buy-out market since the early 1980's although they have been a comparatively rare element of the UK and European markets. In the United States a significant number of these transactions have not been initiated by the incumbent management but by external investors in the form of an LBO Association. They can be divided into six main types depending on the circumstances under which

they arose (Wright, Thompson, Chiplin, Robbie, 1991): as a defence against an actual or anticipated hostile takeover bid; an opportunistic venture by incumbent management; as a hostile Buy-in or LBO; as a response to serious performance difficulties; to allow the transfer of significant/controlling shareholders; and key shareholder dissatisfaction with the share price, analysts' comments or disclosure levels.

The public buy-in however presents an interesting comparison with the US LBO in that the initiative has come from outside with incumbent management not necessarily being involved. Additionally the UK public buy-in may be complete or partial, in the latter case effective power being transferred to the new management team and their investors without having to acquire all the shares and retaining the advantages of a stock market listing.

Buy-outs have frequently provided a means of privatisation from the public sector where a float was not technically appropriate (Wright, Thompson, Robbie,1990). Buy-outs range from the employee buy-out of a complete nationalised industry (National Freight) to those on the break up of National Bus and BTG/NEB. In addition, a substantial number have arisen on divestment of parts of state enterprises such as British Rail and British Shipbuilders as they have undergone major restructuring. Despite the restructuring and turnaround opportunity in many privatisation cases, buy-ins have been rare, reflecting the significant negotiating positions which incumbent management and employees have in such situations. Buy-outs have extended to a wide variety of governmental and quasi-governmental agencies. Buy-outs in the local authority and ancillary health service sectors as alternatives to contracting-out or awards to in-house departments are also occurring in increasing numbers in the UK (Wright, Robbie,1991). However reports by the Audit Commission and the National Audit Office have emphasised that authorities need to take steps to ensure fair bidding procedures and introduce detailed contractual specifications regarding the services to be provided (Audit Commission 1990, CMBOR/NAO 1991).

2.2.4 Motivation for Selling to Management

Before a management buy-out or buy-in can take place, a decision has to be taken to sell by the current owner of the assets whether it is being done on a voluntary or involuntary basis. Bradley, Desai and Kim (1983) explain divestment motivation in terms of information and synergy hypotheses: the target assets may be undervalued in the capital market because investors are not fully informed about future cash flows while an offer presents evidence of the mispricing. Under the synergy argument potential productive gains can only be obtained after the transfer of the assets to the buyer's control. Reasons cited by Hite, Owers and Rogers (1987) included the subsidiary experiencing poor operating results, a lack of fit between parent and subsidiary and a need to raise capital for expansion of other existing lines of business or to reduce high levels of existing debt (ie as an option to the sale of new securities). Divestments may also follow acquisitions. Kaplan and Weisbach (1992) studying divestments made following acquisitions found the most common reasons stated as being changes in corporate focus or strategy, to finance subsequent acquisitions or leveraged buy-outs and performance related reasons. Other possible reasons such as antitrust, needing cash, defending against a takeover and receiving a good price were infrequent.

Vendors may have no overriding preference between divesting via a buy-out or trade sale, companies preferring to deal with the issue on a case by case basis (Bleackley and Hay 1992). Nevertheless individual deal considerations may make a management buy-out preferable to a conventional divestment through a trade sale in circumstances where there may be important non-financial objectives to satisfy- eg a vendor's local reputation, the need for a speedy sale, the possibility of a management walk-out where management are a significant part of the value of the entity or if there are particular problems in long term trading relationships (see eg Wright et al 1991, p 78). Decisions may be complicated if management are suspected of possessing important insider knowledge about the company. Nevertheless, it must be assumed that for a buy-out to take place the management must value the entity more than the vendor and any other potential

acquirer. Some of these reasons are also applicable to buy-in Teams who may also be attractive to the vendor in terms of entrepreneurial skills and business acumen.

Vendor motivation for management buy-outs clearly reflect similar reasons to those in more conventional divestments described earlier. Research has typically concentrated in areas such as strategic and financial distress rationales (see eg Wright et al 1991, Green and Berry 1991, Bleackley and Hay 1992). The former typically revolves around the need to refocus around one or a few businesses by disposing of activities considered now to be non-core as a result of a variety of factors- eg under-performing businesses, excessive diversification, results of previous acquisitions policy. The second may reflect serious cash flow problems within the Group (sometimes as a result of financial problems within the subsidiary or division being divested) forcing the parent company to release funds for the continued growth or survival of the remaining operation. The former can be seen as being equivalent to a voluntary divestment while the latter will frequently be involuntary.

Such views are supported in Wright et al (1991) who reported on a survey of management buy-outs completed in the mid 1980s.

TABLE 2.2: DIVESTOR'S REASONS FOR SELLING

	Divestor		
	UK Parent	Non-UK Parent	All Sellers By Buy-out
Liquidation	5.78	7.00	4.26
Lack of Profitability	3.00	3.10	3.04
Cash Flow Problems	3.35	4.33	3.54
Poor Growth Prospects	3.48	3.89	3.67
Change of Group Core Activities	2.06	2.12	2.31
Company's future capital requirements	3.65	2.89	3.44

Scores are averages, based on 1 = Most important, through to 7 = Least important.

Managers felt (Table 2.2) that the parental decision to redefine core activities of the group was clearly the most important reason for sale, followed by other factors relating to performance. For non-UK parents, future capital requirements of the divested subsidiary was the most important element in the decision to sell.

In an extreme case buy-outs may take place when financial distress has effectively ended the life of the parent group with it being placed in administrative receivership. In such cases management buy-outs may subsequently take place from the receiver. There is evidence that buy-outs may have been attempted in the period running up to receivership but failed because vendors were not prepared to accept the prices being offered by the management. Almost half of managers who complete buy-outs after their companies had gone into receivership had attempted to buy the company prior to it being placed in receivership (Robbie et al 1993).

Since the pressures facing the vendor and consequently his motivation are different in these various circumstances leading to a divestment management buy-out, there may be differences in both the valuation placed by the vendor on the divestment of the business depending on the positive and negative background to the sale but also on that attributed by potential purchasers of the business. A company under financial pressure may accept a lower price for a unit it was divesting whereas one with a stronger background may be able to delay selling until a more advantageous point in the market for inter-firm asset sales was reached. Markets may react differently to the news depending on the type and fullness of reasons given and interpretation of this in terms of future earnings ability of the company and management capability signals.

A further consideration reflects general competitive influences in a market and whether there are trading relationships between the vendor and the subsidiary. Attractions of reducing control costs and possibly gaining benefits from economies of scale and scope that sale to a specialist producer might provide, may be offset by the possibility of a dominant supplier exploiting his position to

charge a higher price. Sale to a management buy-out avoids these problems, as long as the bought out company is more reliant upon the vendor than the vendor is upon its former subsidiary. Where a managed market or quasi-vertical integration relationship is required by the relatively specialised nature of the product, management who have bought out the entity have a stronger incentive to cooperate than may a potential trade buyer. The vendor may also exert pressure by requiring management to bid initially and at subsequent intervals for contracts separately from buying the assets of the business.

In the US, studies by Duhaime and Grant (1984) and Ravenscraft and Scherer (1986) which addressed the strategic rationale behind divestments in the form of sell-offs concluded that they were likely to involve more peripheral businesses and that it was unusual for divested units to have had a vertically integrated relationship with their parent group. However UK evidence from the first half of the 1980s (Wright, 1986; Wright, Chiplin, Thompson and Robbie, 1990b), shows that while the disposal of peripheral activities was a major characteristic of buy-outs, almost two fifths of buy-outs of divisions or subsidiaries sold their products and services to the former parent and around one quarter of buy-outs purchased goods from their former parent. These links, however, accounted for a relatively small share of the buy-out's sales and purchases. For buy-outs from UK parents, the former parent was more likely to be a customer, whilst for buy-outs from non-UK parents a supplier relationship was more probable.

2.2.5 The Influence of M-Form and Agency Cost Considerations

In reaching the decision to divest (2.3.4), major issues arise as to the way that the firm has been organised, whether the structure has allowed the whole and parts to be efficient and whether managers act in the best interests of shareholders. Should the last not be the case, the agency costs (ie the total costs of the opportunities neglected or foregone, together with those of monitoring) may be considerable. The internal structure of the firm plays an important role in checking this (Williamson, 1975, etc). Creation of a multi-divisional form of organisation,

characterised splitting the firm into a strategic headquarters and profit accountable divisions, may reduce the propensity for managerial pursuit of non-profit goals. Headquarters staff constitute a relatively small part of the whole firm, whilst divisional managers, whose promotions and remuneration depend on divisional performance, have lower incentives to misdirect resources..In the strict multi-divisional form of organisation, divisions compete for investment funds, with the head office overseeing this process. The existence of an internal labour market ought to permit better-informed recruitment to senior positions and the possibility of internal promotion and enhance job security ought to encourage employee commitment to the organisation.

A substantial number of studies has tended to support the argument that large complex firms organised into the multi-divisional form have greater efficiency and higher performance than those which are not organised in this way (see Cable, 1988 for a review of the studies). However, there is also strong evidence that many firms apparently organised on a strict multi-divisional basis do not meet the necessary conditions on resource allocation and incentives. Investment funds may not be allocated on the basis of rates of return but as a result of relative internal power relations or strategic planning based on non-profit maximising objectives (Hill, 1984). The problem may be exacerbated by a shortage of internal investment funds provoked by profit crises. Some units may be designated as cash cows and deliberately starved of investment funds even though they have profitable investment opportunities. The functioning of an internal capital market may be hindered by the need to monitor an increasing number and diversity of operating divisions. As a result, increased reliance may need to be placed upon standardised performance targets. With limited central office resources, it may not be possible to intervene directly to raise divisional performance when performance targets are not met.

Internal labour markets may also be problematical. The corollary of increased job security may be decreased responsibility and free-riding. The inability to write complete employment contracts raises the possibility of opportunism on the part of employees. Incomplete employment contracts

give rise to the need for a monitoring function. Senior management may not carry out this function satisfactorily. Moreover, divisional management, especially in the UK, have traditionally been salaried employees with little incentive to engage in profit-oriented activities. The spread of executive stock option schemes and of profit-related remuneration packages has gone some way to reversing this problem. However, there are key issues concerning the proportion of the total remuneration package which needs to be performance related in order to motivate managers, the ability to reward individual performance, the danger of encouraging short-term performance to the detriment of longer term prospects, and the exploitation by divisional managers of an advantage of informational asymmetry, which need to be dealt with. The incentive effects of equity-based remuneration packages may be significant for head office managers (Jensen and Murphy, 1990), but may be less so for divisional managers.

In the absence of congruence between managerial and owners' interests, managers cannot be relied upon to behave efficiently in their adoption of flexibility. As Mueller (1972) and Marris and Mueller (1988) have pointed out, managerially controlled firms may not divest as readily as those which are owner-controlled. The common incrementalist approach to strategy may limit the extent of flexibility by the divestment route (Johnson, 1988). Miller (1982) has drawn a distinction between evolutionary and quantum changes and has suggested that organisational processes lead to the absorption of inefficiencies and that adaptation will be delayed until crisis conditions force change to occur. These points also have implications for the notion of management being involved in a continual search process for the configuration of activities which produces the best returns for shareholders (Cable, 1977). As part of this process, subsidiaries may be acquired which are subsequently found not to fit with the parent firm's overall objectives. Poor fit may mean unsatisfactory performance, but it may also relate to mistakes in acquiring an entity which cannot economically be integrated into the group as a whole. The degree of fit will also be influenced by changing environmental and technological conditions and the life cycle of product markets, so

that something which was originally compatible is no longer (Harrigan, 1980; Duhaime and Grant, 1984). For these reasons, divestment may be required to maximise returns to shareholders.

The ability of firms to adapt to changed circumstances may be constrained by various barriers to exit from existing activities (Harrigan and Porter, 1983). The strengthening of the secondary market in divested divisions and subsidiaries facilitates exit where changing the use to which specific assets may be put may be limited. Where a public auction develops for the control of a division or subsidiary, the vendor ought to benefit from an increased sale price. In a typical case, the outside party may be bidding on the basis of anticipated synergy with its existing financial or operating activities, whilst the insiders act on detailed knowledge of the division's potential. Exit may be facilitated both prior to acute financial distress and as a response to it. In the extreme case of bankruptcy this is self evident. Either a loss making division itself may be sold or a profitable division may be disposed of to restore financial health to the parent. Consequently two main types of rationale can be seen for divestment by buy-out to occur- strategic disposal involving a return to core activities including the disposal of under-performing units- and financial distress- where parents may have severe cash flow problems, are forced to sell release funds for their own future growth and indeed survival (see eg Bleackley, Hay 1992). Of course, firms may not necessarily return to their original core activities but instead may choose to emphasise one or more of the segments into which they have diversified believing greater returns can be earned by so doing.

Divestment of the unwanted parts serves a number of purposes: it is a means by which funds can be raised for acquisition activity in the area with perceived greater potential with a reduced need for outside additional funding; it is a means by which clashes of corporate cultures can be resolved; it avoids control problems which may arise from attempting to monitor two or more very different activities; and it may help as a takeover defence strategy where it enables a low share price, which arises from a firm being seen as a conglomerate to be "corrected".

2.2.6 Corporate Under-Performance and Turnaround

As detailed above a major reason why divestment may occur is because of the under-performance of a subsidiary. Management in both a buy-out or a buy-in will be expected to take rapid remedial action adopting a co-ordinated series of policies and strategies. This Section examines the likely causes of the need for turnaround.

Success will depend on the correct identification of ways in which adverse factors be overcome. The most frequently encountered situations may be seen as where there was a decrease in organisational profitability followed by decreases in sales and market share with less attention being paid to increases in asset utilisation. Financial condition, market position, technological stance and production capabilities were important factors to be examined. In most, regardless of performance area, time is needed especially if the situation of the firm is quite severe.

The causes of the corporate decline which are the prelude to the need for turnaround have been described in a number of studies, eg Argenti (1976), Schendel, Patton and Riggs (1976), Hofer (1980), Slatter (1984), Muller (1985), Grinyer, Mayes and McKiernan (1988) and Zimmermann (1991) and may be internal or external (Hoffman 1989). Turnaround may be seen to lie between organisational decline (eg Ford 1980, Harrigan 1980) and actual failure or bankruptcy (eg Argenti 1976b, Altman 1983, Keasey and Watson 1991). Major problems exist in comparability of the studies in terms of definition of turnaround, size of samples, type of companies included and date of study.

Despite the differences in severity of conditions which warrant turnaround definition, common threads behind reasons for corporate decline in these studies may be seen. They revolve around issues concerning management, competition, market demand, internal and external financial influences, policies and controls, marketing, cost structures, acquisitions, big projects and overtrading.

FIGURE 2.2: CAUSES OF NEED FOR TURNAROUND	
Factor	**Contributory Aspects**
Management	Inadequate skills; skills gaps; lack of depth; ineffective direction, monitoring; neglect of core business; relative roles of CEO and Chairman, combination of roles; leadership and technical abilities of CEO; over cautious v over optimistic styles; failure to create shared vision and values
Financial (internal)	Inappropriate financial structuring including gearing levels; poor financial management and control systems; poor cash flow, working capital, budgetary control; lack of internal communication on financial matters; disputable overhead allocations; unsatisfactory costing factors; tendency to overtrade
Financial (external)	Adverse currency, interest rate and commodity price factors
Cost Structure	Inadequate internal information; poor purchasing management; scale economies not present; learning and experience curve effects; low productivity; low utilisation of fixed assets; competitor may have more favourable location, labour costs; overhead levels; operating inefficiencies (restrictive practices, poor plant layout); government intervention
Market Demand	Secular, cyclical and changing patterns of demand
Production and Labour	Cost; quality; labour force morale; inflexible, outdated practices; poor production layout and control
Marketing	Non focused targets; poor distribution arrangements; possible dependence on single customer; inappropriate advertising focus; lack of sales incentive motivation; lack of market research; promotional aspects; lack of new product development
Competition	Products over priced; lack of product market focus; undifferentiated product; unjustifiable high price because of cost structure; lack of product development and ideas for new products; comparatively poor after sales service
Acquisitions, Divestment and Prestige Projects	Earlier acquisitions of losers (eg weak competitive position in own market; overpricing of acquisitions; poor post acquisition management; misdirection of management time to potential acquisitions and to big, prestige projects; financial over runs following poor costing and commissioning delays; divestment of non core or loss making subsidiaries may not have been made at the appropriate time

Additionally symptoms of the decline may also have been in evidence through decreasing profitability, decreasing sales volumes at constant prices, increase in debt, decrease in liquidity, restricted dividend policy, accounting practices, top management fear, rapid management turnover, declining market share and lack of planning/strategic thinking (Slatter, 1984) as well as organisational and ethical problems (Zimmermann, 1991). The actual changes are likely to have been triggered by one or a multiple of events, the more dramatic sharpbends being associated with multiple triggers (Grinyer, Mayes and McKiernan, 1990). These include intervention from external bodies, change of ownership or the threat of such a change, new chief executive, recognition by management of problems and perception by management of new opportunities.

Figure 2.2 illustrates the major areas where problems are likely to exist in companies which require turnaround and the types of problem which may be evident within these areas. Individual cases are likely to show considerable variance between each other; studies involving case study approaches to a significant number of companies (eg Slatter 1984, Grinyer, Mayes and McKiernan 1988, Zimmermann 1989, 1991) and others based on implications of a single or small sample of cases (eg Zimmerman 1986, Melin 1985, Robbie and Wright 1989 a etc) confirm the multitude of different factors which lie behind corporate decline which leads to the need for turnaround. Consequently studies may not be strictly comparable.

Management has been seen as the single most important factor behind much corporate decline with inadequate overall managerial skills, the existence of skills gaps, ineffective vision, direction and monitoring, and the questionability of the role and abilities of Chief Executives especially where they also act as Chairman. Performance may be affected both by over cautious CEO's at one extreme and over optimistic ones at the other. CEO's may lack vision of the company or fail to share their vision and values.

Financial factors also play an important role. External financial factors, which may largely be out of the sphere of control of the firm, can influence the decline- eg adverse currency movements, high interest rates or sudden movements in commodity prices, especially where hedging devices have not been used. Internal financial problems may arise from poor control mechanisms, inadequate working capital control and low emphasis on cash flow, lack of budgetary systems and monitoring, inappropriate costing systems, unjustifiable overhead allocations and inadequate financial communication with and lack of financial education of non-financial departments. Financial structuring through perhaps excessive gearing for the type of company may have aggravated the company's financial stability.

Related to these financial areas may be a cost structure which is too high, reflecting not only inadequate information and controls but also lack of scale economies. Fixed assets may be under utilised while productivity may be low. Overheads may be excessive and competitors may have access to cheaper factors of production. Government policy may have distorted cost structures.

Management may also have engaged in an unwise acquisition strategy, eg by acquiring companies which turned out to have a weaker competitive position in their own markets than expected. The price paid may in retrospect have been excessive while post acquisition management may have been poor or have resulted in a misdirection of senior management's time from other pressing problems in the company. Similarly management may have misdirected resources into big projects which involved high capital expenditure and significantly altered gearing levels. Over-run of financial costs, communication problems, commissioning delays may have added to the management and financial strains on the parent company.

The level and mix of sales may have been depressed through poor marketing, competitive factors and changes in the market. Marketing targets may not be adequately focused, there could be over reliance on one or a handful of large customers. Promotional aspects and advertising may not be

adequate and sales incentive systems inappropriate for current market conditions. Market research may be incomplete or wrong. Sales may also be affected by fears over the state of new product development.

The overall product markets within which the company operates may also be affected by various long term factors which may be difficult for the company to control. It could be subject less severely to a cyclical decline which will affect the short term prospects. More seriously there may be a long term secular decline in demand which will warrant more severe turnaround action. Within the market there may be changing patterns of demand which may affect one firm which does not adjust differently from others.

Management may have seriously under assessed the effects of competition. This may be not just price but also product related, eg a growing technical gap, lack of ideas for new products. There may be a lack of product market focus while on pricing grounds the product may be uncompetitive because of the high cost structure.

The company's poor position may also reflect production and labour problems. Low productivity and or morale may have affected both the costs of production and the quality of the finished product. Production and labour practices may be inflexible and outdated aggravated by poor production layout and controls.

Should there be need for turnaround, remedies may be found internally; in other cases the existing owners of the form may no longer wish to institute the necessary change and seek alternatives through new ownership structures.

2.3 The Team Leader and the Team

2.3.1 The Role of the Entrepreneur

The phenomenon of Entrepreneurship is essentially multi disciplinary (Gartner 1985) with definitions of entrepreneurship varying significantly depending on the type of background (eg economics, psychology, sociology, politics) of the commentator. Reviews of research into entrepreneurship show that many researchers have effectively used a wide spread of definitions with few employing the same definition (see eg Gartner, 1990) leading to major criticism of lack of homogeneity, both within and between samples, to lack of homogeneity of research. Indeed the startling number of traits and characteristics attributed to the entrepreneur has been seen to produce overall a person larger than life, full of contradictions, and, conversely, someone so full of traits to be a sort of generic 'Everyman'. Despite entrepreneurship research surfacing in the fields of cultural anthropology, history, political science, education, sociology, mass communications and economics, Wortman (1986) notes that few main line researchers from management, marketing, accounting or finance have chosen to work in this area.

It is clear that the meaning of the terms entrepreneur and entrepreneurship varies considerably between different theorists and researchers. In bringing together qualities of the entrepreneur from various theories, Hebert & Link (1988) have suggested various themes (see Table 2.3). The entrepreneur assumes the risk associated with uncertainty; supplies financial capital; is an innovator; decision-maker; industrial leader; manager or superintendent; organiser and coordinator of economic resources; owner of an enterprise; employer of factors of production; a contractor; an arbitrageur; and an allocator of resources among alternative uses. While this covers a large variety of characteristics, the entrepreneurship writings of Schumpeter and Leibenstein are seen to be of particular relevance.

TABLE 2.3: ENTREPRENEURIAL THEMES IN ECONOMIC LITERATURE	
Assumes Risk associated with uncertainty	Cantillon, Thunen, Mangoldt, Mill, Hawley, Knight, Mises, Cole, Shackle
Supplies financial capital	Smit, Turgot, Bohm-Bawerk, Edgeworth, Pigou, Mises
Innovator	Baudeau, Bentham, Thunen, Schmoller, Sombart, Weber, Schumpeter
Decision Maker	Cantillon, Menger, Marshall, Wieser, Amasa Walker, Francis Walker, Keynes, Mises, Shackle, Cole, Schultz
Industrial Leader	Say, Saint-Simon, Amasa Walker, Francis Walker, Marshall, Wieser, Sombart, Weber, Schumpeter
Manager or superintendent	Say, Mill, Marshall, Menger
Organiser and co-ordinator of economic resources	Say, Walras, Wieser, Schmoller, Sombart, Weber, Clark, Davenport, Schumpeter, Coase
Owner of an enterprise	Quesnay, Wieser, Pigou, Hawley
Employer of factors of production	Amasa Walker, Francis Walker, Wieser, Keynes
Contractor	Bentham
Arbitrageur	Cantillon, Walras, Kirzner
Allocator of resources among alternative uses	Cantillon, Kirzner, Schultz

Source: Derived from Hebert and Link (1988)

Schumpeter perceived the entrepreneur 'to be an extraordinary person who promotes 'new combinations' or innovations (Cheah, 1990). The entrepreneur thus reforms and revolutionises 'patterns of production by exploiting an invention, or more generally, an untried technological possibility for producing a new commodity or an old one in a new way by opening up a new source of supply of materials or a new outlet for products or by re-organising an industry...(This) requires aptitudes which are present in only a small fraction of the population and that define the entrepreneurial type as well as the entrepreneurial function' (Schumpeter, 1950). The entrepreneur required not only technical skills and ability but also was expert in the use of

intuition and strategy. Clearly the Schumpeterian entrepreneur is primarily interested in the successful transformation of an existing situation rather than the creation of a totally new venture although the range of innovation outlined includes the creation of a new type of organisation of industry and in particular the creation (or indeed destruction) of a trust or monopoly. He however is extremely innovative. Furthermore the Schumpeterian entrepreneur appears to be a short term phenomenon: the entrepreneurial element only exists for as long as the introduction of the new combination of inputs lasts and loses this character as soon as the business has been built up. Thus he guides the enterprise through its formative period of development into a stage of growth and maturity. Additionally Schumpeter does not see entrepreneurial functions as being performed by managers or capitalists. Consequently the entrepreneur is not a risk bearer, the function of the capitalist, and is not identified by the position he holds. He appears to have a managerial or decision making role. He is identified by the function he performs- innovation. The changes introduced by Schumpeter's entrepreneur are major and discrete involving major discontinuity and disequilibrating effects.

Leibenstein subsequently looked at entrepreneurship in terms of his work on X-efficiency with the x-inefficient world being one of permanent slack implying the existence of entrepreneurial opportunities and developed this into the identification of two distinct types of entrepreneurial activity. 'At one pole there is routine entrepreneurship, which is really a type of management, and for the rest of the spectrum we have Schumpeterian or "new type" entrepreneurship (N-entrepreneurship)' (Leibenstein 1966, 1968). The entrepreneur in both cases co-ordinates activities that involve different markets but in routine entrepreneurship he is operating in well established and clearly defined markets. In N-entrepreneurship however not all the markets exist or operate perfectly and the entrepreneur must fill in for market deficiency. The entrepreneur connects different markets, makes up for market deficiencies, is an "input completer" and creates or expands firms. Entrepreneurship is also a scarce commodity as entrepreneurs are gap-fillers and input-completers which are scarce talents. The personality factors of entrepreneurs were seen as

important as apart from gap-filling and input-completing capacities, the potential entrepreneur's response to opportunities will depend on their preference for certain modes of behaviour as opposed to others. Relevant to buy-outs and buy-ins is Leibenstein's theory development to look at the supply of and demand for entrepreneurs drawing further conclusions that some entrepreneurial characteristics could be in surplus supply; some types of input, eg certain types of higher education provided to potential entrepreneurs, seen as being normally functional may in fact prove to be dysfunctional; and training may be able to increase the supply of entrepreneurship and help to assess areas of opportunity once perceived.

2.3.2 Entrepreneurial Characteristics

Reliability of investigation into entrepreneurial characteristics clearly suffers from the different interpretations as to the definition of entrepreneurship by various researchers. The problem is compounded by small samples in many surveys, static terms of reference and non-comparability of samples. Additionally much of the earlier entrepreneurship research may be seen to be over-descriptive rather than identifying causal relationships and deriving implications for practice. Hofer and Sandberg (1987) note that entrepreneurial factors may be only one of several (eg industry structure and strategy, personal environmental and strategic variables) which are relevant. Indeed many surveys appear to attribute characteristics to entrepreneurs which could just as easily apply to executives.

Entrepreneurial characteristics may be classified into three areas but with certain overlap: general, psychological and motivational and parental and own entrepreneurial experience. Topics covered under general background characteristics include education, age, culture, religion, disadvantaged minorities and immigrants. The last four also form part of the parental group along with parental business ownership and self employment. Psychological and motivational aspects include need for achievement, tolerance for ambiguity and risk taking propensity. Issues relating

to religious and cultural background, age and education are discussed below, entrepreneurial experience issues in 2.3.3 and psychological and motivational factors in 2.3.4.

(i) Age

The most appropriate age at which the decision to become an entrepreneur is made has been seen as being between twenty five and forty, eg Shapero (1971), Mayer and Goldstein (1961), Cooper (1973) and Howell (1972). This age range, Liles (1974) suggested, was more a 'free choice period' when the individual sees himself as able to act and follows a period of rapid increases in experience, competence, and self confidence and is followed by a time of rapid increases in personal financial and other obligations and also a shift in values to encompass areas in addition to career. Susbauer (1969) however found the age of high-technology entrepreneurs at the time of company formation closely paralleled the distribution of the general population between the ages of 25 and 60.

Hunt and Collins (1983) also suggested that people working in large corporations in their mid-thirties undergo a period of rethinking their goals and ways of life which may provide the impetus for starting their own business. Gibb and Ritchie (1981) postulated that the entrepreneur has different attitudes to risk depending on his age and this affects the development of his business. Slatter, Ransley and Woods (1988) note that the majority of USM Chief Executives started their firms in early and middle age, their 30's marking 'decision points' in their life. 3i (1992a) note that breaking out' of corporate employment might reasonably be expected to peak when managers reach their mid-forties, a time when the frustrations of working for someone else grow and the individual re-assesses how he wished to spend the remainder of his working life.

(ii) Education

Education is an important issue as it may give an insight into whether entrepreneurs are born or can be created through training (see eg comments on Leibenstein above). Indeed the most likely

entrepreneurs to fail would be those with experience but no education and the second most likely those with education but no experience (Vesper 1980). Conversely entrepreneurs with both experience and education would be associated with the most profitable business enterprises. Casson (1982) argued that further education was advantageous but not essential for the private entrepreneur. This reflects firstly that professional skills are not essential to the private entrepreneur provided he knows how to delegate to professionals and to motivate those that he employs and secondly that formal education has an opportunity cost in terms of on-the-job training forgone; time spent in academic pursuits could have been spent 'learning the trade' as a delegate entrepreneur. However in many cases formal education is used to obtain qualifications which give exemption from all or part of training programmes. The potential entrepreneur may thus begin his career in a post where he is delegating tasks he has not had to perform himself, and as a result the motivation he can supply to his delegates and quality of supervision may be poor. Additionally formal education may inculcate uniform attitudes among entrepreneurs and so destroy the individuality and diversity of their views.

Brockhaus and Nord (1979) in their comparison of owners of new businesses to managers found that the period of education of entrepreneurs was less than for managers. The latter with their higher levels of education may have been able to obtain more satisfying jobs or alternatively to find more desirable employment elsewhere. Managers with less high educational qualification may however have decided to start their own venture. For instance it should be noted that in this study the average period of education for entrepreneurs was in fact higher than the national average. Douglas (1976) compared studies to census data and showed that entrepreneurs have more education than the general population although majority of Cooper and Dunkelberg (1986)'s sample had less than a college degree. Generally results into educational characteristics have frequently been distorted as much research has been directed at industries such as specialist high technology sectors where high levels of intelligence and education appear as prerequisites.

Education may have an important influence on entrepreneurial performance as at different stages of the development of the firm the small business owner/manager will require different mixes of entrepreneurial and administrative skills (Brockhaus 1982). Education may have an influence on other crucial variables such as open-mindedness, business ideology, information processing and general performance. As the firm grows, more knowledge of managerial, strategic and planning techniques and principles may be required.

Nevertheless investigation into the relationship between level of education and venture performance has produced mixed returns. Roubidoux and Garnier (1973) for instance showed that the more educated the entrepreneur, the higher the rate of growth of the firm. In contrast, however, Douglas (1976) found no significant correlation between educational background and rate of growth and Stuart and Abetti (1990) a negative relationship of education with performance. The latter noted that it was not just that those with PhDs who were doing poorly but those with limited education were doing well. Education was also negatively correlated with entrepreneurial experience implying that those who went out and started companies early rather than going on for advanced education did better.

In the UK the link between entrepreneurship and educational background has been identified in several studies. Educational qualifications can be seen as being very important in reducing the constraints imposed by personal wealth (Casson, 1982) as they give entry to establishment institutions and thereby regulate the entrepreneur's access to other people's capital. Better educated entrepreneurs were expected to pose a more aggressive threat to large companies in the future (Scott, 1976, Stanworth and Curran, 1973). Storey (1982) noted that academic qualifications are a necessary but not sufficient condition for entrepreneurial success while Pickles and O'Farrell (1986) noted that the level of education was highly significant. The probability of founding a new business was seen to peak at a complete secondary level of education. It however then fell steeply for those who advanced beyond secondary level. Although additional educational qualifications

may reduce the likelihood of entrepreneurial behaviour, there was evidence that firms owned by graduates were more successful than companies run by entrepreneurs with fewer educational qualifications.

(iii) Culture and Religion

Another issue is whether particular sections of the population are more likely to become entrepreneurs. Throughout history particular social and cultural groups have been identified with entrepreneurship. These include Jews, the Lebanese, various immigrant groups (eg Kenyan Asians in the UK or Cubans and Indo-Chinese in the United States) and frequently come from some displaced set of circumstances. Hard-working and with high abilities to form new companies they appear to have had a significant economic impact. Studies have shown contrasting levels of entrepreneurship in different countries (McLelland 1961) while others have pointed to particular ethics arising from religion which might help to explain this phenomenon.

Weber (1930) argued that the Protestant Ethic had encouraged hard work, thrift and striving for material advancement which had helped to advance capitalism and economic development. Hill (1961) however points out that there is nothing in Protestantism which automatically leads to capitalism: what is important is that many of the old obstacles put in place by the Catholic hierarchy and thus preventing earlier development of capitalism were effectively undermined. Low and MacMillan (1988) argue that there must be congruence between ideological constructs and economic behaviour if entrepreneurship is to flourish.

Another major alternative cultural theory was advanced by Hagen (1960) who saw disadvantaged minorities seeking redress of social grievance as displaying entrepreneurial behaviour. This may arise from displacement by force (eg war, political upheaval), denigration of valued symbols (religion), inconsistency of status symbols with changes in the distribution of economic power; and non acceptance of the expected status of immigrant groups. A development of this theory

(Brenner 1987) is that it is those groups which have lost or face the prospect of losing social status that are driven to take entrepreneurial risks. These people could for instance include what is described by Shapero (1975) as displaced persons- people who are forced to make career decisions such as new graduates, discharged servicemen and immigrants. In many cases they are going to have nothing to lose through entrepreneurial actions and this way may be the only way forward for them. Studies such as Collins and Moore (1970) have demonstrated a high rate of such people in a population of entrepreneurs. Brockhaus (1982) notes that the foreign immigrant born with more limited opportunities may have regarded ownership of small businesses more favourably than the native born who was able to choose from a much wider range of occupations.

2.3.3 The Relevance of Entrepreneurial Experience

Another important issue is whether direct or indirect experience of entrepreneurship is able to influence further entrepreneurial activities and performance, Teams learning from previous experience. Team members may have had previous entrepreneurial experience, for instance through having established a company earlier, selling it off and starting another one or alternatively starting up a new company following the failure of an initial venture. Mayer and Goldstein (1961) noted that it was fairly common for an owner-manager to own and run several different businesses during his lifetime; whereas experience as an employee in a given line of business did not ensure success as an owner in the same line, previous experience as an owner was important, particularly so if in the same line of business. Lamont (1972) noted that entrepreneurs with previous experience in founding and developing a company exhibit substantial learning when they start a new business; more often than not their experience was reflected in superior corporate performance. Cooper (1971) noted that many of the entrepreneurs he studied had formed more than one company and many had experienced previous business failures. Vesper (1980) confirmed that entrepreneurs who had started one organisation tended to be more successful and efficient in the start-up of their second and third organisations. Stuart and Abetti (1990) in examining factors behind early performance in new ventures noted that the most

significant variable in their study was the entrepreneurial experience of the leader reflecting the number of previous ventures and the role played in them. A related measure, the previous level of managerial experience, similarly showed high correlation with performance.

Ronstadt (1988) in advocating the 'corridor principle' argued that multiple entrepreneurs are relatively common and that the best new venture opportunities are most often revealed after an individual is already involved in a start-up. The entrepreneur gains more access to relevant contacts, viable markets, product availability, competitive resources and response time. The use of earlier ventures may produce an 'experience curve' which may significantly help the multiple entrepreneur to overcome problems and obstacles (Executive Forum 1986).

Studies in the UK also indicate that a significant number of new firm founders had previous experience of owning and managing a business (Lloyd and Mason, 1984; Mason, 1989; Storey, Watson and Wynarczyk, 1989) and to a more minor extent in Turok and Richardson (1991).

A further important determinant of entrepreneurial background is seen to be the occupation of the entrepreneur's father and in particular whether he has been an entrepreneur or small business owner. Parents are likely to play the most powerful part in establishing the desirability and credibility of entrepreneurial action for an individual (Shapero and Sokol 1982) as well as family as being a potentially valuable source of information with the nature and extent of the family's connections influencing the opportunities available to the entrepreneur (Casson 1982). A family tradition of business ownership exposes the young potential entrepreneur to 'role models' and to the educational experience of learning what is involved in owning and managing a business. Pickles and O'Farrell (1987) suggested that a household in which the father was self employed may have exposed the potential new firm founder to the expertise and values of entrepreneurship and in the household there may have been a commitment to the ideology and to the nature of the reward system inherent in self employment. Litvak and Maule (1971), Roberts and Wainer

(1971), Roubidoux (1975), Shapero (1971), Susbauer (1969), Collins and Moore (1970), Shapero and Sokol (1982), O'Farrell (1986), Cooper and Dunkelburg (1986) and Donckels and Dupont (1987) all suggest that an unusually high percentage of entrepreneurs had fathers who were also founders of new ventures, entrepreneurs or farmers. Such findings are however not universal, eg Brockhaus and Nord (1979) finding managers and new entrepreneurs no different as to whether they had any close relative had owned a business. Indeed there seems no justification in assuming that having a parent with entrepreneurial experience will in itself mean that the individual is a better entrepreneur.

2.3.4 Psychological and Motivational Aspects

Although discussion of the typology of entrepreneurship has provided researchers with different models of entrepreneurs, the factors on which these are based are clearly extremely important. Despite the diversity of factors noted earlier, the search for common areas of characteristic psychological factors received significant attention for some period of time. Major reviews of the literature in this area have been provided by Brockhaus and Horwitz (1986) and Low and MacMillan (1988). Nevertheless it should be noted that there have been criticisms of attempts to identify and measure personality traits of the entrepreneur using conventional psychological techniques (Stevenson & Sahlman, 1989) with the ability to attribute causality to these factors seriously in doubt. This may be partially caused by differing definitions of the entrepreneur, the inadequacy of the research design and the measuring instruments (Chell et al 1991).

(i) Need for Achievement

Heavily influenced by the study of the achievement motive by Murray (1938), McClelland (1961) based his research on the need for achievement (nAch), those with a high nAch having a strong desire to be successful. They possess attributes (McClelland 1962) such as taking personal responsibility for finding solutions to problems; set moderately challenging achievement goals and take calculated risks; and want concrete feedback regarding performance. McClelland

demonstrated that high nAch scores and subsequent manifestation of these behaviours correlated strongly with entrepreneurial success. McClelland hypothesised that Protestantism (self-reliance values, the work ethic, etc) led to independence and mastery training by parents, to high nAch in sons, and ultimately to the spirit of modern capitalism and economic development.

The nAch model, however, can be criticised from several perspectives. These include biased data selection, analysis and interpretation; seriously underestimating the impact of social factors while overestimating the importance of psychological variable in the economic growth equation; the low predictive validity and low re-test reliability of the Thematic Apperception Test; and the extremely wide spread of entrepreneurs included in his sample which resulted in him not directly connecting nAch with the decision to own and manage a business.

Brockhaus and Horwitz (1986) point out that while the research continues to find that entrepreneurs are high achievers, the same thing could be said about successful executives. Thus a definitive link between achievement motivation and entrepreneurial success have not necessarily been established. In an analysis of research in this area Johnson (1990) however concludes that the lack of definitive research results regarding the link between achievement motivation and entrepreneurship is more likely to be the result of flawed research methodology rather than the absence of a positive relationship.

A further aspect related to the need for achievement is the belief in an internal locus of control. Rotter (1966) explains that an individual perceives the outcome of an event as either being within or beyond his personal control and understanding. Thus it could be expected that entrepreneurs perform best in situations where they have personal responsibility for results, ie they are internally rather than externally controlled (Berlew, 1975). Several other studies eg Shapero (1975), Brockhaus (1975); Panday and Tewary (1979) and Borland (1974) have confirmed that entrepreneurs are more internal in their locus-of-control beliefs than the general population.

Several other studies (Brockhaus and Nord 1979; Mescon and Montanari 1981; Sexton and Bowman 1985) have however indicated that there were no significant differences between entrepreneurs and managers. Brockhaus and Nord (1979) compared the locus of control beliefs in entrepreneurs and managers and while the mean scores did not differ significantly between the owners of new businesses and entrepreneurs, the mean score for entrepreneurs was lower than all but one of the earlier studies. Brockhaus (1982) feels that an internal locus of control belief may therefore be associated with a more active effort to affect the outcome of events. This internal belief and the associated greater effort would seem to hold true for both successful entrepreneurs and successful managers. While it fails to distinguish entrepreneurs uniquely, it holds promise for distinguishing successful entrepreneurs from the unsuccessful.

Sexton and Bowman (1985) in reviewing their earlier studies comparing potential entrepreneurs to potential managers noted that potential entrepreneurs were found to have a significantly lower need for conformity (indicating self-reliance and independence), interpersonal affect (indicating emotional aloofness), harm avoidance (indicating an unconcern for physical harm), and succorance (indicating a low need for support, sympathy, reassurance or advice). They had a significantly higher need for risk-taking (indicating a willingness to expose themselves to situations with uncertain outcomes), social adroitness (indicating subtlety and persuasiveness), autonomy (indicating self-reliance and independence), and change (indicating an ability to adapt readily to changes in the environment).

(ii) Risk Taking Propensity

Another aspect of the psychology of the entrepreneur is his ability to take risks. Clearly both management buy-outs and buy-ins involve degrees of personal risk taking which are significantly different from those encountered in a normal managerial role. Issues arise as to whether entrepreneurs are prepared to take higher degrees of risk than the general population; Palmer (1971) for instance saw the entrepreneurial function as primarily involving risk measurement and

risk-taking. McClelland (1961) however argued that people with high nAch actually had only moderate risk taking propensities. It is in the high belief in their ability to influence the achievement of business goals that the perceived possibility of failure is relatively low. Mancuso (1975) states that established entrepreneurs tend to be moderate risk takers. Brockhaus (1980) found no significant statistical difference in the general risk preference patterns of a group of entrepreneurs and a group of managers and indicate that the risk taking propensity does not distinguish new entrepreneurs either from managers or from the general population. Brockhaus (1982) suggested later that the perception held about two components of risk- the perceived probability of failure and the perceived consequences of failure for a specific venture (which had not been included in the earlier study)- may be due more to specific environmental conditions rather than to personality related characteristics. Indeed the financial backer/ investor may have far more to lose than the entrepreneur (see, eg Webster 1977).

Low and MacMillan (1988) in their review of entrepreneurship research suggest that it is perhaps more insightful to view entrepreneurs as capable risk managers whose abilities defuse what others might view as high risk situations. Lisle (1974) points out that risk is not just financial but includes career, family/personal and psychic elements. Kets de Vries (1977) argues that more often than not a great decline in prestige and status income is a common phenomenon in the initial phases of entrepreneurship. The 'purgatory of entrepreneurship', ie the period preceding recognition of one's entrepreneurial abilities can be a time of extreme hardship during which considerable socio psychological sacrifices have to be endured. Naturally a certain tolerance for economic risk is necessary but a tolerance for psychosocial risk might be more important.

(iii) Displacement

A buy-out or buy-in may be precipitated by some action which produces essentially a displacement motivation- eg threat of redundancy, plant closure, bankruptcy, move of location, limitation of future prospects, for instance being overlooked for promotion or even being demoted.

Displacement may arise as a response to lack of social mobility through other channels. A person may become just totally bored with a job function or frustrated with the way the company is run and feel that he can do significantly better on his own, being fired or feeling that one could run the company better, economic conditions, geographic isolation (see eg Susbauer (1982), Draheim (1982), Shapero and Sokol (1982), Cooper (1970), Vesper (1983)). In the UK Boswell (1972) identified the emigration of frustrated men from corporations as being a prime generator of new engineering and hosiery/knitwear firms. Brockhaus compared successful and unsuccessful entrepreneurs and found that the former were more dissatisfied with previous jobs at the time when they decided to start up their businesses. An employer's lack of understanding of the entrepreneurial personality may lead to a work environment full of frustration leading to the employee leaving and indeed creating new competition.

At the same time it is evident that not everybody who suffers displacement will react by setting up a new business, seek to buy-out or buy another company. The displaced individual may, for instance, seek employment with another company. The course of action chosen will also depend on the individual's perception of alternative courses of action. This may depend for instance on the general level of economic activity.

Storey and Jones (1987) and Hamilton (1989) have suggested that the level of employment loss in redundancies and establishment closures may push individuals into self-employment and new firm formation. Storey and Jones in studies of the East Midlands and the North of England found evidence that suggests that local labour market conditions are of greater importance in influencing local rates of new firm formation than national indices of profitability. The transition to self-employment is seen as the outcome of a subjective calculation. When individuals reckon that the discounted stream of monetary and non-monetary net benefits of being self-employed exceed those of remaining in their present positions, they will move into self-employment. Hamilton (1989) notes, however, that there is a critical level of unemployment estimated to be about 20

percent where further rises in unemployment will be associated with falling business formation rates. Binks and Coyne (1983) noted a high proportion of entrepreneurs in their sample had been 'pushed' into starting their own businesses. However the 'push' sources were seen to offer a less reliable source of future growth as a smaller number are likely to enter new product markets or introduce innovations in techniques of production. Pickles and O'Farrell (1986) noted in their Irish survey that there was no evidence of self-employment being associated with or in response to unemployment although there was some evidence of association with double job holding experience. Gould and Keeble (1984) observed no recession-related increases in firm formation with periods of upswing in the economic cycle stimulating the highest levels of entrepreneurship.

2.3.5 Entrepreneurial Typologies

Clearly there are attractions in trying to obtain classifications of entrepreneurial types to see if entrepreneurs possess homogenous characteristics. Indeed this may be of particular relevance in comparing buy-out and buy-in Team Leaders. The search for key variables to differentiate frequently do not stand up under close scrutiny. Rather there may be many different types of entrepreneur and the creation of a new venture is a multi-dimensional phenomenon. Vesper (1980) for instance identified eleven different kinds of entrepreneur, Webster (1977) five types, Stanworth and Curran (1976) three types (artisan, classical and managerial), and Gartner (1983) eleven entrepreneurial archetypes while Woo, Cooper and Dunkelberg (1989) indicated that entrepreneurs in different industries can be very different from those in others.

With such diversities evident among entrepreneurs it is not surprising that efforts have been made to see if entrepreneurs can be grouped together according to certain common characteristics (Smith 1967; Braden 1977; Filley and Aldag 1978; Dunkelberg and Cooper 1982; Smith and Miner 1983; Lorraine and Dassault 1987; Davidsson 1988; Woo et al. 1988; Lafuente and Salas 1989; and Woo, Cooper and Dunkelberg 1991). Individual studies in the main have successful

entrepreneur while examination may reflect more on entrepreneurial traits as a product of entrepreneurial experience.

However studies have generally identified two main types of entrepreneurial individuals: craftsmen and opportunists. Smith (1967) saw the craftsman as having less education and work experience, being essentially blue collar and less adaptive to change. He is likely to run his business in a hands-on manner and be paternalistic to his employees. He runs his business for intrinsic satisfaction, such as independence and autonomy and neither financial gain nor growth are key motivations. Deeks (1973) also noted that owner-managers do not make financial gain their key reward. In contrast the opportunist had managerial orientation, better education and broader experience and were from a more middle class background. Opportunists have been seen as more adaptive to change, more flexible, seeking more diverse sources of external financing, having more balanced attention to different tasks and adopting formal plans. Given that many opportunist entrepreneurs have earlier managerial experience, they may start their entrepreneurial career later than the craftsman, perhaps spurred into action by a mid-life crisis (Scott 1976). Filley and Aldag (1978) suggest a three way classification, differentiating craftsmen, promotion and administrative organisation types. Slatter, Ransley and Woods (1988) argue that entrepreneurs can be divided into Classical, craftsman, opportunist and R & D entrepreneurs.

Woo, Cooper and Dunkelberg (1991) additionally point out that the opportunist entrepreneurs are more likely to be motivated by financial gains and the opportunity for building a successful organisation while the craftsmen entrepreneurs were likely to have narrow educational and managerial experience, had primary motivations of 'making a comfortable living' as opposed to 'making a lot of money', avoided risk-taking and were less likely to seek multiple investors or partners.

While research into entrepreneurial typologies has been essentially carried out in North America two major studies have been published identifying typologies in two European countries. Lafuente and Salas (1989) looked at 360 owners of Spanish private firms and deduced that the two entrepreneurial types of 'craftsman' and 'opportunistic' were not sufficient to describe the Spanish population of entrepreneurs. Lafuente and Salas saw four main categories: the craftsman, giving an opportunity to prove oneself or build something perfect; managerial, working in a prestigious company, the opportunity to develop oneself; security/family, build family welfare; and risk-challenge, work, diversity as key motivation. Different paths to becoming entrepreneurs also emerged: 'managerial' individuals became entrepreneurs relatively more often through inheritance, 'craftsmen' more often through the purchase of the firm (ie through a management type of action), and finally 'family' and 'risk' entrepreneurs reach that situation more often through founding. However no clear patterns emerged between entrepreneurial types and personal characteristics, management and performance.

Westhead (1990) presented a typology of six founder types of 269 new manufacturing firm founders in Wales. The contrasting routes to new manufacturing firm formation led to different founder types to establish firms that had contrasting levels of performance. Individuals drawn from families with a strong entrepreneurial tradition and who have held professional and managerial positions in small locally controlled manufacturing establishments have acquired the necessary skills and made the necessary contacts that have enabled them to establish new firms with potential for employment and wealth creation.

However caution must be exercised in the examination of entrepreneurial typologies. Not only may differences between entrepreneurs and non-entrepreneurs be excluded but the type of analysis involved requires much personal interpretation. While similarities may be seen to link studies, there may be major hidden divergences while direct comparisons may not strictly be possible because of different methodologies and instruments employed across studies.

2.4 Infrastructure Aspects

2.4.1 General Concepts

Another important element in the development of entrepreneurship and with some overlap into networks is the presence of other factors which may make the overall environment suitable for generation of opportunities such as new ventures, buy-outs and buy-ins. These can be seen to include national, regional and local factors and cover areas such as the presence of local market contacts; incubator industries; technical manpower resources; universities with appropriate doctoral and research programmes; research laboratories of major companies and government; sources of venture capital; commercial banks; local stock underwriting firms); appropriate formal and informal advisers; attitudes towards entrepreneurship and presence of skilled entrepreneurs; opportunities for interim consulting; economic conditions; and favourable government policies (see eg Vesper and Albaum (1979), Cooper (1970, 1971, 1973), Bruno and Tyebjee (1982) and Pennings (1982)).

In applying environmental factors to the UK, Lorenz (1989) has also referred to social barriers (eg the social unpopularity of trade and industry as a career and preference for the professions); educational barriers (eg discrimination against industry within school curricula); employment security (until the 1980's job mobility in the UK was relatively low); the ability to develop teams which embrace both qualities of technical entrepreneurship and disciplined business management skills; fiscal handicaps limiting both the ability of a new entrepreneur to invest a significant amount of personal capital in a new venture or the disincentive of a capital gains tax rate the same as income tax; and concerns shown in surveys over the ability to fund the small business and the possibility that the gain would not justify the effort. Robbie and Wright (1991) have also remarked on the importance of fiscal and legal restraints which may make buy-out and buy-in transactions difficult to engineer efficiently, the presence of professional advisers skilled in these transactions and the existence of adequate funds to finance such ventures whether they be provided by venture capitalists or banking sources.

Within Europe there are still considerable differences in the state of buy-out (Chiplin, Coyne and Wright, 1987) and buy-in markets (Clutterbuck, Snow, Wright, Robbie, 1990). Actual activity and future prospects for buy-outs and buy-ins in Europe can be seen to be dependent on the presence of three main factors (Wright, Thompson, Robbie, 1992): the generation of buy-out opportunities; the infrastructure to complete a transaction; and opportunities for the investors in a buy-out to realise their gains. These broad issues may be further sub-divided. The generation of opportunities will be heavily influenced by attitudes to entrepreneurial risk and hence willingness of managers to buy, the ownership structure of industry and hence the generation of entities which are for sale and the state of development of mergers and acquisitions markets.

The measurement of attitudes to entrepreneurial risk is perhaps rather difficult, although authors have recognised that marked differences do exist between countries (Tyebjee and Vickery, 1988). Additionally the entrepreneurial culture of a country will cover not only the entrepreneurial orientation of individuals but also its presence in formal institutions such as banks and venture capital firms and can be expected to change over time. Within the UK attitudes towards the acceptability of entrepreneurship changed significantly during the 1980's (Lorenz, 1989). Bannock (1990b) noted that in France, Germany, Italy and the UK attitudes towards 'breaking-out' (ie carrying out a buy-in or buy-out) had become significantly more favourable over the previous ten years reflecting funds being more readily available and were more market opportunities. The establishment of role models as well as changes in culture towards risk taking were also cited as less significant but also important reasons.

The infrastructure to complete transactions includes sources of funding both in respect of venture capital availability and the ability of banks to fund transactions, the nature of legal and taxation regimes and the existence of intermediaries and advisors who can both identify and negotiate buy-outs and buy-ins (eg Wright, Thompson, Robbie 1992, Ooghe et al 1991).

2.4.2 The Importance of Incubators

The process of identifying the appropriate target company is an essential and time consuming part of the buy-in process. Major issues arise not only concerning the methods used but also relating to the relative backgrounds and experience of the team. In this context the role of incubators is likely to be important. Low and MacMillan (1988) point to a diversity of definition for incubators, ranging from simply the organisation where the entrepreneur worked prior to launching a venture (Cooper, 1985) to Smilor and Gill (1986)'s understanding of a formally organised facility offering laboratory and other space, support services, technical and business consulting services, and contact with other entrepreneurs.

Incubators appear to influence the processes by which entrepreneurs, at particular times and places, leave to start new firms. Particularly relevant factors are its size; the extent to which there are negative factors or 'pushes' associated with the decision to leave it; the relationship between the business of the incubator and that of the new firm; and whether the incubator is geographically located closeby (see eg Cooper and Dunkelberg 1985). Cooper (1985) and Gibb and Ritchie (1982) in particular have emphasised the importance of the nature of the last organisation for which the new founder worked prior to the new venture.

Employees who work in small firms are generally seen as being more likely to start a business than those who have been working in large organisations. The small firm incubator is likely to provide broad work experience including exposure to technology and markets which will be important factors in the new venture. Cooper (1971), Johnson and Cathcart (1979), Storey (1982), Gould and Keeble (1984) and O'Farrell and Crouchley (1984) confirm that small companies are likely to have significantly higher spin-off rates of entrepreneurs than larger organisations. Cooper and Dunkelberg (1986) note that a further factor favouring the small company entrepreneurial background is that they may in the first place have attracted more entrepreneurial inclined employees who are then exposed to the role model of the company president. Westhead (1990)

hypothesizes that employees working in large factories are not provided with the relevant experience necessary for entrepreneurial training and management. In contrast the presence of a very active small firms sector can provide plenty of examples for potential founders to follow: contact with other small firms could be made as part of an employee's job, and informal contacts with potential and actual founders may be more likely.

A further important aspect is the activity of the incubator organisation. Clearly the ability to draw upon the technical and market knowledge acquired in the incubator organisation will encourage the entrepreneur to found businesses in fields which he already knows (Mayer and Goldstein 1961; Hoad and Rosko, 1964; Cooper, 1970, 1985; Storey 1982; Johnson and Cathcart, 1979; Cross 1981). Cooper (1985) noted that the new firm typically depends on what the founder knows or can do which is often related to what he learnt in the incubator organisation. Implications are that the nature of new firms started in an area is likely to be related to the nature of organisations already there and that organisations may vary widely in the extent to which their employees acquire the skills and knowledge that could be easily applied to starting a new firm.

The incubator provides an important source of information about commercial opportunities and gives individuals particular skills and outside contacts. While new firm founders may improve on the products and services offered by their former employers, in practice many ventures may initially reproduce products and services rather than offer anything technically or organisationally new.

A further issue is whether the activities of some incubators will be more appropriate for generating change. Westhead (1990) notes that since industries vary widely in the extent to which they offer opportunities for new ventures, the strategy of the incubator organisation determines to a great extent whether its employees will ever be in a position to spin off and start their own businesses. An established organisation in a mature industry with little growth and heavy capital

requirements is unlikely to have many spin-offs. New firm formation can be expected to be depressed in areas which are dominated by industries with high barriers to entry although it could be countered by the contrary argument that individual workers in such industries may have a range of engineering and management skills that could be applied to starting new enterprises in another industry (Mason, 1991). New firms may be closely related to the business of incubator firms for most high-technology firms but less so for other manufacturing and service firms (Cooper and Dunkelberg 1986). Those who purchased organisations (ie a set of circumstances similar to the UK management buy-in), although searching for businesses they knew well, may be less likely to be involved in a business closely related to what they did before (Cooper 1985).

A further issue is whether the entrepreneur moves from the area where he has been working. There are clear advantages in that starting in the same geographic area in that it permits the founder to draw upon personal contacts and market knowledge, to start if necessary on a part-time basis while keeping an existing job, and to avoid the disruption of a family move. Confirmation that founders are most likely to establish businesses close to their existing home or work can be found in studies such as Cooper (1970), Susbauer (1972), Watkins (1973), Johnson and Cathcart (1979), Cooper (1985), Gould and Keeble (1984), Birley (1985) and Hakim (1988).

Incubators also have a significant role to play in the formation of teams necessary for the new venture providing the setting within which teams can be formed (Cooper and Dunkelberg 1985). Cooper (1985) observed that members of founding teams often meet each other in the incubator organisation while teams in themselves permit the assembly of a broader range of skills.

2.4.3 The Role of Networks

Issues arise as to the methods and contacts employed by entrepreneurs in identifying and establishing venture opportunities. Within complex networks of relationships, entrepreneurship is facilitated or constrained by linkages between aspiring entrepreneurs, resources and

opportunities (Aldrich and Zimmer 1986) Both management buy-out and buy-in processes require varying uses of networks which in the case of buy-ins could extend to help in the identification of a target company. Entrepreneurs typically differentiate between two kinds of networks (Birley 1985): informal (eg family, friends, previous colleagues, or present employers) and formal (banks, accountants, lawyers, Chamber of Commerce, local and central government agencies). Dubini and Aldrich (1991) further develop the types of network by including the company's activity and structure through the co-existence of two different types of network- extended networks associated with organisations and the informal, personal networks associated with individuals.

Formal networks are seen as often being expensive and time consuming, most of them offering help to the entrepreneur only as a small part of their service; additionally they are not in the business of diagnosing needs but rather responding to specific requests. In contrast informal networks are frequently less informed about the options and schemes open to the entrepreneur but may be more willing to listen and to give advice. While entrepreneurs rely heavily on the informal network extensively, they seem seldom to tap into the formal network, entering it at a late stage, eg at the point of arranging bank finance. However the type of network used may vary with the stage of development of the firm and its size, the emphasis moving to professional bankers, accountants, lawyers suppliers and even government agencies in later stage and larger ventures (see eg Birley et al 1991, Cooper et al 1989).

2.4.4 The Venture Capitalist

Networks will be particularly relevant in the search for venture capital for a new venture, buy-out or buy-in. The entrepreneur has to use appropriate means to identify and approach an appropriate venture capitalist and then undergo a process of both business proposition and personal examination by the venture capitalist. His ability to understand fully the process involved will strongly influence both his own buying decision and hence selection of the most appropriate

venture capitalist but also the ability of the venture capitalist as supplier of funds to find a deal which meets its appropriate deal quality and projected rate of return criteria.

A key issue however relates to the relative roles of venture capitalists and management in initiating transactions. In order to reduce the constraint of a deal flow controlled by third parties, a number of venture capitalists may actively search for deals themselves. Tyebjee and Bruno (1985) note the ways in which venture capitalists monitor the environment for potential candidates through an informal network. Venture capitalists may also use direct marketing activities (Robbie and Murray 1992) although this is relatively undeveloped in the UK (Cranfield 1990). The difficulty of gaining consumer recognition is high for a service that remains an 'occasionally bought' product for most entrepreneurs with few UK entrepreneurs able to recognise other venture capital firms other than 3i (Llanwarne 1990).

Considerable variations exist in the organisation, size, activities and targeted markets of individual venture capital firms with only a few covering all areas of the market (Venture Economics 1991), the majority focusing on particular stages and size of investment and some on specific geographic regions (Martin 1989), industrial sector(s) or technology (Dixon, 1991). Major differences may emerge in how long the venture capitalist is prepared to be an investor, and the type of relationship between the venture capitalist, the CEO and his board (eg Rosentein et al 1993). The entrepreneur has to identify the most appropriate venture capitalists not only for initial deal completion but also for the longer term relationship (Lorenz, 1989, Bygrave and Timmons 1992). However, a significant part of the investor's decision will rely on the personality and background of the individual applicant, the characteristics of the management team and the interpersonal chemistry created between the two parties. Venture capitalists have their own individual prejudices and approaches to selection. Individuals seeking equity funding need to recognise this diversity and adjust their approach accordingly to different providers (Hisrich and Jancowicz 1990).

Few venture capital proposals are accepted, the most common reasons for rejection being the qualities of the entrepreneur and/or an unattractive assessment of the market by the venture capitalist. Professional assistance through the use of intermediaries in practice increases the chances of the proposal not being rejected at the earliest of stages by the venture capitalist (Robbie and Murray 1992).

Given the initial information asymmetries between applicants and providers (Dixon 1991), the search period for venture capital support is often onerous and time consuming for new ventures (Bruno and Tyebejee (1985) and buy-outs (Wright, Normand, Robbie, 1991). Particular problems are clearly involved in management buy-ins where a target company has to be identified as well as a satisfactory purchase price agreed with the vendor and finance obtained from the venture capitalist. In this process the entrepreneur relies very much on his own experience in identifying a suitable target and few on their financing institutions or accounting advisers while the buy-in Team Leader may have a conflict of interest which results in him having to resign his existing employment.

In searching for venture capital finance unsolicited cold calls from entrepreneurs approaching the venture capitalist directly without any previous connection represent the largest volume of proposals received. Referrals may come from a wide range of sources including other venture capital companies; associate or parent organisations; clearing and merchant banks and other finance providers; existing venture capital clients; and past successful entrepreneurs (Lloyd and Mason, 1984, Storey, Watson and Wynarczyk, 1989, Tyebjee and Bruno 1985). If entrepreneurs do not have direct knowledge of the venture capitalist (Hall and Hofer 1993), other contacts whose track record the venture capitalist appreciates- such as lawyers, bankers, accountants, consultants and business school faculty- could be utilised. Of these (in the UK) accountants represent the key, independent, financial intermediaries with whom the venture capitalists associate (Robbie and Murray 1992).

In approaching potential sources of finance Teams may have received negative advice from advisers concerning venture capitalists including fears about the release of equity (eg Lanwarne 1990, Johnson 1991) or may have different rankings as to the potential uses of venture capital than the venture capitalists themselves (Colville 1991). However many professional intermediaries may not have had personal contact with a venture capitalist (Hovgaard 1991) while professional managers may have a better understanding of the role of venture capitalists than entrepreneurs in general (Murray 1991a).

Formal intermediaries may play an important role in searching for finance. The complexities of management buy-out and buy-in financing require that entrepreneurs seek professional accountancy advice and guidance for both personal and corporate reasons at an early stage of their search for capital (eg Sharp 1991, Kreiger 1990, Omerod and Burns 1989, Franks and Blackstone 1990, Wright, Normand, Robbie, 1991). The accountant may also front negotiations with the vendor in a management buy-out and frequently plays a major role in the final preparation of a Business Plan to present to the venture capitalist. The accountant is also the first source of advice to the majority of entrepreneurs considering additional sources of finance (Llanware 1990). Frequently, the accountant assumes a major responsibility in generating and reviewing competing offers from venture capitalists to an attractive proposal.

In seeking finance the accounting adviser is likely to play an important role in refining the Business Plan. This provides an important aid to the screening process (Lorenz, 1989, Sharp, 1991); several studies (eg MacMillan, Siegel and Naraimha 1985, Dixon 1991) confirm the critical weighting given to the personality, commercial experience and employment history of the entrepreneur. Tyebjee and Bruno (1985) note four features which are particularly important- the marketing factors and the venture's ability to manage them effectively; the products' competitive advantage and uniqueness; quality of the management team, especially in its balance of skills; and exposure to risk factors beyond the venture capitalist's control. MacMillan et al (1985) deduce

that venture capitalists appear to assess ventures systematically in terms of the risks of losing the entire investment; being unable to bail out if necessary; failure to implement the venture idea; competitive risk; management failure; and leadership failure. Despite sophisticated quantitative analysis, the intuitive impression that the entrepreneur makes on the venture capitalist executives remains extremely important in the final decision of whether or not to invest. This process must be seen as two-way: it is extremely important for the entrepreneur to realise that he can have a long term relationship with the venture capital firm and its personnel.

This essentially subjective evaluation at times may seem to amount to 'gut feel' analysis (eg Hisrich and Jankowicz 1990) but is frequently justified in terms of the funding being just the first stage in a continuing and often intimate relationship between the funder and the investee's management team. The success of that relationship, including the professional advisory services that the venture capitalist may provide and the willingness of the entrepreneur to be influenced by external parties, may be very material in influencing the successful outcome of the venture. Issues relating to the post transaction governance are discussed in 2.6.5.

Once interested in a proposal, the venture capitalist will carry out extensive due diligence, a process which has been described (Silver 1985) as a series of five audits: the size of the problem the business is attempting to solve, the elegance of the solution, the entrepreneurial team, the financial statement and legal aspects. In doing so (Sharp 1991) the venture capitalist will carry out a factual verification of the company's trading history and statement of fact in the business plan; management review; product and technical appraisal; independent market review; references; and accountant's investigation. The completion of the process will allow the venture capitalist to assess whether the proposal is attractive enough with which to proceed or if it should be renegotiated on terms different from those originally indicated or indeed whether an investment should be made under any circumstances. It will also indicate areas in which warranties from the vendor should be carefully worded. As well as commissioning reports from reporting accountants, the

venture capitalist will also commission independent reports where necessary and take up extensive references both on the company and its standing in the market as well as on individual members of the Team.

To carry out satisfactory due diligence is a time consuming and costly procedure which may produce difficulties where there is competition for purchasing the company. Clearly there may be considerable dangers to the plan should due diligence not take account of all relevant factors and a decision by financiers made too quickly on the viability of the business proposal.

2.5 Deal Completion

2.5.1 Financial Structuring

A key element of corporate restructuring was the development in the late 1980's of much more highly geared financing structures with debt assuming a much more important role than hitherto at the same time as the introduction of a much greater link between ownership and control of the company through a review of equity incentives and governance systems.

Proponents of corporate restructuring argue that the increase in debt was both inevitable and beneficial. First the trebling of the market value of U.S. public-company equity during the 1980's meant that corporate borrowing had to increase to avoid de-leveraging. Secondly debt creation without retention of the proceeds of the issue helps limit the waste of free cash flow by compelling managers to pay out funds they would otherwise retain. Interest payments are effectively a substitute for dividends bonding managers to pay out future cash flows in a way which simple dividend increases or share repurchase schemes do not. Debt therefore forces management to disgorge cash, limiting their opportunities for spending cash flows on projects with low or even negative returns. Borrowing allows for no such managerial discretion, the breaking of interest obligations and/or covenants moving the company towards the declaration of insolvency or even the bankruptcy courts. Thirdly debt can be seen as a powerful incentive for change. High

rates of leverage may create a feeling of crisis which forces managers to slash unsound investment programmes, shrink overheads and dispose of assets that are more valuable outside the company. The proceeds from this action can then be used to reduce debt to more sustainable levels, creating a more efficient and competitive organisation. Violation of bank covenants could also be expected to create a board level crisis bringing new actors onto the scene, motivating a fresh review of top management and strategy and accelerating response allowing actions to be taken more quickly.

Support for the role of bankers may be seen in suggestions that those lending to the firm may be better able to control the activities of its managers than are equity owners- not least because of the sanction of refusing to renew loans (Stiglitz 1985) while Cable (1988) demonstrates the importance of banker involvement for German firms. Nevertheless between 1989 and 1992 in both the UK and US there was considerable evidence that financiers may have misjudged levels of optimal leverage with both refinancings and bankruptcies of many large and highly leveraged buy-outs being necessary (see Shleifer and Vishny 1992 and Kaplan and Stein 1993), the sheer weight of available finance, especially junk bonds, being a contributory factor. Supervisory authorities became active in their monitoring of the HLTs (highly leveraged transactions) of banks. This contrasts with problems in the early 1980s which were solved within relatively short time scales by re-organisation frequently with new management. While in retrospect some may attribute this development to overpricing and consequent over-leveraging (Jensen, 1991), it does raise questions as to the way in which larger buy-outs in particular are completed, competition between buy-out funds, the structure of renumeration of both fund executives and fees charged by funds and the quality of due diligence carried out.

The main issues involved in overall financial structuring are described below in terms of the major financial instruments used.

(a) Equity

Key features of buy-out funding are the significant monitoring and control roles of the external equity providers (see 2.6.5) while management are given large equity incentives to perform thereby reducing the agency costs seen in the traditional corporate relationships. To do this involves different forms of equity finance and the re-writing of traditional monitoring and control aspects attributable to different classes of shares.

Equity will normally be subscribed in the form of Ordinary Shares and Preference Shares (Wright and Robbie (ed) 1991, Franks and Blackstone (1990), Wright Normand, Robbie 1990). While the financing institutions may occasionally subscribe for ordinary shares which have the same basic rights as those of the entrepreneur and his team, for the most part they will subscribe for variants, which may have some or all of the following characteristics: convertibility, stated redemption dates, cumulative and/or participating dividend rights, preferred status in the winding-up of the company and mechanisms whereby ratchet stakes may be activated. A full set of monitoring rights will be built into the Articles of Association including board composition and will restrict management's action in terms of areas such as acquisitions, divestment, diversification and capital expenditure (see Robbie and Wright, 1990a). This will be supplemented by a Shareholders Agreement which will formulate the relationship between management and investor in more depth.

A key element in the structuring of a buy-in or buy-out with external equity finance is that managers with very limited resources are able to acquire what may be very large businesses and obtain a share which is disproportionate to the amount of capital put in by the entrepreneur. Only rarely does flat pricing occur in which management pay the same pro rata for their Ordinary and Preferred Ordinary Shares as the institutional backers (see eg the case of Mallinson Denny, Robbie & Wright 1989b). Consequently the amount of finance subscribed by managers may be expected to represent a small fraction of the purchase price.

In some cases a performance ratchet on equity is used under which beyond the levering effect built into the initial deal structure, further gains in equity share may be made by management on achievement of certain pre-agreed targets (Thompson and Wright 1991). These are normally one or a combination of: cumulative profits over a particular period, market capitalization on exit within a specified time period, redemption of financing instruments, meeting of the investor's internal rate of return targets or combinations of these. Alternatively the equity may be scaled down if targets are not met, providing the choice by the financing institution depending on their perception of the management to adopt a 'stick or carrot' approach.

Although ratchets may theoretically be expected to maximise incentives to perform, in practice they can cause protracted disputes between institutions and management both at the time of the negotiation of the buy-out and over its interpretation when the ratchet is crystallised. Accounting based payments may reward effort but they suffer from the disadvantage that accounting numbers are subject to excessive manipulation (eg Healy 1985). Flexibility in UK accounting rules (Taylor and Turley, 1986) provides scope for alternative interpretations of the conditions specified in a ratchet formula. For example, disputes may arise over the treatment of exceptional gains from the sale of assets affecting the outcome of the ratchet formula. Such issues may become particularly important in cliff-edge ratchets where at the margin a small increase in apparent profits can lead to a large increase in managerial equity stakes. Particular problems may exist in reconciling the objectives of all parties in syndicated deals which have to be refinanced.

(b) Debt

While much of the basic financing concept for a management buy-out or buy-in is likely to come from the external equity financier, his ability to achieve acceptable rates of return as well as that of the management entrepreneur to obtain a disproportionate size equity stake for the level of funds committed derives from acceptance of banks (and more recently mezzanine players) to provide relatively high levels of debt, thereby leveraging up management and equity institutions

returns. In Going Privates the proportion of debt in the capital structure more than triples on average (Marais, Schipper and Smith 1989). The optimum amount of debt in the financing structure will be influenced by a number of factors. The ratio of borrowing to equity, the capital gearing ratio, may in itself provide little guidance. Rather than relying heavily on some 'carcass value' of assets, as in the traditional clearing bank approach, emphasis shifts to the ability of the firm to meet the costs of servicing and repaying debt. The optimal capital structure is also significantly influenced by the development of a secondary market in assets and the costs of its operation. In an imperfect world, any lowering of the costs of operating markets for the control of corporate assets should reduce the costs of financial distress and so shift the optimal capital structure in the direction of greater leverage. That is, the amount which may be recovered when a business unit is sold in distress circumstances is likely to be higher when buyers exist who are willing to pay a price which includes both the value of tangible and intangible assets. The more favourable the economic context, the more debt is used in financing a takeover and less outside equity used (Grammatikos, Makhija and Thompson 1988).

In assessing the financial suitability for a buy-out, financiers will assess income gearing or coverage ratio, that is the ratio of profit before interest and tax to interest payments as well as the ratio of free cash flow to debt interest. However, whilst such ratios may be satisfied at the outset it is necessary to ensure that they will also be met throughout the expected period of the buy-out's financing structure. Sensitivity exercises under varying assumptions about markets, costs, etc. will need to be carried out to establish the likelihood of problems occurring. The amount of investment required will also affect the free cash flow to debt interest ratio. For these reasons, appropriate targets for buy-outs are generally firms operating in mature and stable markets, with relatively low investment needs and which are highly cash generative. Unbundling or selling-off surplus assets may be used to pay down debt to levels which can comfortably be serviced from trading profits and free cash flow. Firms vulnerable to general economic conditions which affect

variable interest rates paid on the debt may frequently protect themselves through the use of hedging techniques such as interest rate swaps, caps and collars.

(c) Other Forms of Finance

Where adequate senior debt is not available, mezzanine debt may be used to fund the financing gap. Mezzanine is a form of subordinated debt generally accompanied by an 'equity kicker' of some form, eg warrants to subscribe to equity at a future date (Bartlam 1992). Mezzanine has been used to bridge a financing gap where the price of the deal may too high in terms of conventional bank asset backing, with a high degree of goodwill or conventional senior debt returns would dilute the returns to the equity providers including management to make the transaction unacceptable. Lack of asset backing may be countered by significant positive cash flow. This form of finance has a level of risk which intermediate between senior debt and equity with commensurate intermediate return.

In addition to these three main forms of finance, alternative sources may be required to ensure that a buy-out or buy-in can be completed at an acceptable price to the vendor (see eg NAO/CMBOR, 1991, Robbie, Wright, 1992a). These range from the provision of deferred loans (traditionally interest free and subordinate to all other debt) to direct participation in the equity of the company, sometimes through preference shares or more frequently through ordinary shares or a warrant convertible into ordinary shares should the company be sold or floated on the stock market. Such devices serve two functions in that they both provide what may be an essential layer of finance without which the buy-out or buy-in would not be possible to complete as well as through equity participation protecting the vendor from charges from shareholders that they have not participated in any uplift of value in the company should it be sold in a relatively short term at a price which implies undervaluation in the original buy-out/in. Vendor loan notes have also been used, allowing vendors where the loan note has been guaranteed by a prime name of receiving the discounted value of the note immediately after buy-out completion. Such procedures

may allow the buy-out to be financed on much more attractive terms than if mezzanine finance had been used. Additionally vendors may employ earn out escalation clauses allowing them to receive additional payment should certain levels of profitability be achieved. Vendors may also provide non-loan methods of helping the divested subsidiary under its new ownership- for instance the provision for a certain period of rent free premises or the guarantee of a certain level of turnover where there is a mutual trading arrangement.

Besides vendor finance other sources of finance are frequently employed in buy-outs and buy-ins. These may include instruments such as leasing, hire purchase, factoring and invoice discounting such as the effects of improvements in working capital management- extension of facilities with creditors and better control of debtors.

2.5.2 Pricing and Ensuring Fair Value for Vendors

Major issues surround the pricing of buy-out transactions and ensuring that vendor shareholders receive a fair price for the assets sold. While such concerns apply to all sources of buy-outs, most research has revolved around going privates. Concern may of course not be so great in management buy-ins where the bidder is external. Increases in share valuation may be attributable to two main arguments: heightened expectations of a control transfer which will lead to value-increasing changes in the firm's operation; and the hypothesis that managers propose a buy-out when they have favourable inside information about the firm's value which is unrelated to the buy-out transaction, such inside information contributing to managers' proposal decisions. Clearly a prime motivation in proposing a buy-out may be that the firm's shares were undervalued. Kaplan and Stein (1993) found some confirmation that US large buy-outs in the later 1980s became over priced because as the large availability of junk bonds forced up acquisition prices generally and especially those buy-outs where junk bonds were used.

The largest batch of studies relate to "going private" deals in the U.S. (DeAngelo et al 1984, Smith 1990, Kaplan 1989, Marais, Schipper, and Smith 1989, Lehn and Poulsen 1989 and others reviewed in Amihud 1989 and Yago 1989b). These typically examine the announcement effects of LBO offers on the stock price of the target. However since a bid premium is almost always necessary by an unquoted bidder to secure the stock, a positive market response is virtually inevitable except in exceptional circumstances. Studies show that the size of the average bid premium over the equity value sometime before the announcement (typically two months) appears to be over 40 percent with compensation of as high as 76 % in cases involving multiple bidders (Lowenstein 1985). UK bid premia for going private buy-outs are in line with those for hostile takeover bids (see Chiplin, Wright, Robbie, 1990). The size of the firm (Amihud 1989), the level of undistributed free cash flow and managerial equity holdings (Lehn and Poulsen 1989), the target industry's adjusted price-earnings ratios (Travlos and Millon 1989), the degree of risk (Grammatikos and Savory 1986) and the relative compositions of boards between independent and non-independent directors (Rosentheim et al 1992) have been identified as other determinants of the magnitude of the premium. Lee (1992) deduced that managers of firms with completed buy-outs are no more likely to have access to inside information than managers who withdrew proposals.

While announcement effects literature has concentrated on going privates, a smaller set of studies has examined the effect of divestment announcements on share price effects on the vendor parent. These studies have covered equity carve-outs, spin-offs and sell-offs as well as management buy-outs. Hite and Owens (1983), Schipper and Smith (1983 and 1988), Klein (1985), Denning (1988) and Alfsar et al.(1990) suggest that on balance the announcements have had a positive effect on security returns.

An announcement effect study of divestment buy-outs in the US by Hite and Vetsuypens (1989) found small but significant wealth gains to vendor shareholders in the two days surrounding the

announcement of the sale. Alexander et al (1984) and Denning and Shastri (1990) found no significant excess return associated with divestment. Similarly Madden et al (1990) reported positive excess returns on Management Buy-outs. However Briston et al (1992) in examining UK divestments by management buy-out showed that shareholders do experience negative excess returns following the announcement of a management buy-out although the decision to sell parts of the assets of the parent company to management tends to be announced after a period of positive abnormal return. MBO teams may therefore have been able to negotiate their deal at a price lower than their current market value to the parent or lower than the expected value to an outside buyer. This latter survey may have been distorted by a significant number of small management buy-outs, while most of the US studies may have been focused on extremely large transactions.

These increases in stockholder wealth appear substantially to exceed any gains made by downgrading senior debt (Marais et al 1989, Jensen 1989a) or from tax benefits of the buy-out (see KKR 1989). Pre- buy-out bondholders may however suffer small losses (Asquith and Wizman 1990, Cook, Easterwood and Martin (1992) confirm the presence of significant bondholder wealth losses of about 3 percent associated with the announcement of management buy-outs.

A major concern clearly is that management may have manipulated accounting or other information. However DeAngelo (1986) found no evidence of biased information in an analysis of accounting data. DeAngelo (1990) examined the valuation procedures used by US investment bankers in going privates: they were seen to make use of accounting data in conjunction with share price information, comparative prices of other company acquisitions, management forecasts, etc. Accounting information used included a wide range of valuation techniques and sensitivity analyses including analyses of comparable firms, comparable acquisitions, discounted cash flow analysis, leveraged buy-out models and leveraged re-capitalisation models. De Angelo concluded

that the ultimate buy-out price is constrained to fall within the approximate range of value implied by a broad variety of valuation techniques.

Despite the lack of evidence, concern over the use of insider information and the potential for manipulation of data by unscrupulous managers has led to several proposals being made both in the US and UK for control. In the US concern about losses to shareholders led to proposals for a mandated auction particularly as some evidence suggested that premia tended to be higher in such instances (Lowenstein 1985). Amihud (1989) has expressed serious reservations pointing out that while premia are higher in competitive bidding contests, mandated auctioning may actually reduce the probability that an initial auction is made as potential bidders fear that the likelihood of success be reduced in a competitive bidding situation. The result of a mandated auction may be fewer buy-outs and consequent economic losses from the benefits they can create not occurring.

Bruner and Paine (1988) argued that managers have certain fiduciary obligations and concerns about conflicting interests, insider advantages and misappropriation of corporate opportunities reflect management's special obligations to the corporation and its shareholders. By refinancing the company with debt managers may be able to leverage up the value of the firm at the expense of existing shareholders. They suggested that management should pay a price equal to the value that would be placed on the company if shareholders were to refinance the company the company with debt, a 'synthesised' buy-out, themselves. Jones and Hunt (1991) dismiss the utilitarian defence of buy-outs.

Schadlera and Karns (1990) note that control over information is an ordinary and expected part of the responsibility of a firm's management and suggest that in the short term as a legal device the management buy-out process should be seen as being comparable to a preliminary merger

negotiation with an external firm, while in the longer term the disclosure protection provided by security laws should be extended to management buy-out transactions.

In the UK following proposals made by the Investment Committee of the National Association of Pension Funds (NAPF 1989) at the time of the controversy surrounding the going private of Magnet, the Takeover Panel in December 1989 issued new rules including requirements to appoint an independent adviser to the offeree board; rules on the secrecy with which such a buy-out may be organised, prohibitions on share dealings by those with privileged information; provision of information provided to prospective financiers to all shareholders and other bidders and a description of the proposed financing structure. In turn these rules raise questions as to the desirability of passing confidential information to a bidder who may be a competitor and whether the opportunist manager who launches a bid for his company is serving his company better than a board which agrees a bid with another company without exposing the company to proper take-over criteria. It is also easy to forget the real risks to managers which are present in these transactions. Furthermore the issues have to be seen in the general context of the increasing interest in corporate governance and whether increased share ownership of the directors and management could have a beneficial effect. For example Amihud (1989) has suggested that management and the buy-out specialist could buy the necessary controlling interest without actually going private and thereby achieve the necessary incentive structure and control mechanism.

Concerns as to ethical and insider trading considerations are clearly in most cases not applicable to buy-ins, giving them a significant advantage. External management seeking to acquire a company are not in a position of privileged information and have to make a bid on the basis of the information available to them. Incumbent management and other shareholders may dispute the valuation placed by the external management bidder but have to mount a defence to show why such valuations may be unrealistically low while the option remains open for either internal

management to mount a bid or another party to do so to determine a more realistic value. Thus the Isosceles buy-in resulted in competing bids between management and the external management bid. Public buy-ins in the UK may also meet some of Amihud's suggestions: the partial public buy-in allows a wider group of shareholders to retain an interest in the company and profit from any subsequent success. Alternatively the use of stub equity in several UK buy-out and buy-in transactions gives vendor shareholders the chances of benefitting from long term restructuring (Wright, Thompson, Chiplin, Robbie 1991)

2.6 Post Transaction Issues

2.6.1 Buy-out Performance: The Issues

Two particular theoretical approaches indicate that improvements may be expected in the performance of firms which are subject to buy-outs: Agency Theory and Entrepreneurship Theory (Bull 1989).

Jensen (1989b) suggests that the characteristics of buy-out deals ought to produce reductions in agency costs (see 2.2 above). First, the use of quasi-equity and debt-related instruments introduces a commitment to perform on the part of managers since if they fail to meet the cost of servicing such funding, the providers of such funds have the power to remove them. Second, these institutional financiers and investors are motivated to defend their debt and equity interests using other control devices such as board representation, detailed access to information, etc which may enhance performance. Third, the existence of significant managerial equity stakes may reduce previous differences between principals and agents which heightened agency cost problems (in general, increasing management equity raises the risk of management and entrenchment, Demsetz and Lehn, 1985; however in the particular context of a management buy-out this difficulty is countered by the role of debt and institutional control devices). These issues may relate to buy-outs of whole companies quoted on a stock market (Jensen, 1989b), companies which were part of a state owned entity (Wright, Thompson, Robbie, 1990b) and inappropriate and restrictive

hierarchial control in the case of buy-outs of divisions of larger groups (Wright and Thompson, 1987). Companies or divisions of larger firms which have stable business histories and generate substantial free cash flow (ie low growth prospects but high potential for generating cash flow) are likely to be suitable candidates for leveraged buy-outs (Jensen, 1986). Before the buy-out transaction fixed asset investment may not have been in projects earning optimal returns while there may be significant organsiational inefficiencies. The venture may be expected to be successful because of the strong interest which the managers and venture capitalists have in that their equity investment is subordinate to other claims. Success will require (inter alia) implementation of other changes to avoid investment in low return projects to generate the cash for debt service and to increase the value of equity. While an agency relationship does still exist (albeit in a different form), the primary objective of debt repayment is shared by both the principals and agents.

It can of course be argued that high levels of debt may result in assets being unloaded at less than their cost, the "fire sale" approach while also limiting the amount of finance available for expansion. It may give the buy-out a certain inflexibility compared to competition and it is questionable whether it involves transferring resources in a way which increases market power.

Entrepreneurship theory would suggest that rather than simply involving mechanisms to control agency costs, buy-outs enable managers to be alert to take advantage of opportunities for growth. Bull (1989) argues that as the new group of owners is small in number and includes top managers, most owners will tend to be personally involved in the business and can be expected to observe and exploit opportunities for personal gain. Baumol (1988) describes the entrepreneur as a person who acts in accordance with the reward structure of the economy; this in the 1980's in the UK could be seen to be orientated towards the pursuit of wealth. Chell (1985) argues that the limiting factors on the growth of a business are the entrepreneur's capabilities in terms of having the necessary skills to cope with the increased information which will arise from the greater number

and variety of situations which he or she will encounter and the need to negotiate if the business is to grow and/or be successful.

Entrepreneurial experience of the Team Leader has also been shown as the most significant single variable in determining successful early performance (Stuart and Abetti 1990). Vesper (1980) demonstrated that a variety of experience in different formal areas and prior entrepreneurial experience (even failure) was an indication of better performance. MacMillan et al (1985) showed the venture capitalist's strong dependence on the entrepreneur's personality and experience and a lesser dependence on the market, product and strategy.

Although entrepreneurship theory implies that performance should benefit from higher degrees of innovative action, performance may also vary at different stages of the entrepreneurial process and if different types of entrepreneur adopt varying mixes of operating and strategic actions. A major problem clearly exists in that through the wide variation of some studies and the statistical problems inherent in small samples, it may not just be entrepreneurial characteristics in much of the research but also environmental and strategic variables which are important.

The actual act of mounting a buy-out may be seen as highly entrepreneurial (Green and Berry 1991, Wright and Coyne 1985). Furthermore the buy-out enables managers to undertake actions which they were not able to do within the well known restraints of large multi-divisional organisations (Wright and Thompson 1987). Entrepreneurship is probably more evident, and more critical, in the case of management buy-outs where the group of entrepreneurial managers/owners are striking out on their own for the first time (Wright and Coyne, 1985, p5). Agency cost and Entrepreneurship approaches overlap to some extent since the equity ownership incentive mechanism contributes both to reducing agency costs and encouraging managers to seek out and exploit opportunities.

In addition to the performance benefits which may be expected from Agency Cost and Entrepreneurship Theories, the fact that in management buy-outs the businesses acquired are established ones with experienced managers should imply higher success rates than many other new ventures (eg Hanney 1986). The venture capital and bank screening processes may also significantly improve the chances for success with their stringent investment criteria.

2.6.2 Buy-out Performance: The Evidence

This review of buy-out performance concentrates on operating and financial performance, UK and European studies, the role of management equity stakes and employment considerations. Before examining these studies in more depth, problems in their interpretation must be noted. First virtually all the US studies refer to large buy-outs, with average size considerably greater than the average UK buy-out with many being of "going private" transactions, a relatively minor element of, the UK market. Many of the samples are relatively small, giving rise to the possibilities of biased results. There may also in some cases be a bias towards the more successful buy-outs, eg some refer to cases which have been bought out and then are floated on the stock market within a relatively short period. Indeed questions may be asked as to why such improvements were not achieved before and whether they can be maintained into the longer term.

(a) Financial and Operating Performance

The majority of studies examining operating performance confirm the beneficial effect of the LBO on profitability (DeAngelo, DeAngelo and Rice 1984), return on equity (Lowenstein 1985), revenue growth (Singh 1990), working capital (Smith 1990), better utilisation of resources (Scherer 1986) and productivity (Yago 1989a). Efficiency benefits appear more significant in divisional buy-outs as opposed to independent buy-outs (Singh 1990, Muscarella and Vetsuypens 1990)

A necessary caveat is that most of these studies concerned leveraged buy-outs which occurred in the early and mid 1980's. In the later 1980's the leveraged buy-out market had developed to the point where pricier and riskier transactions took place (Kaplan and Stein 1990, Jensen 1991, Summers 1989) implying that real operating gains may have been more difficult to achieve in the later deals. Opler (1992), however, in a survey of 1985-89 buy-outs, shows that these were not accompanied by smaller operating improvements than observed in the earlier studies suggesting that they were not 'more marginal' as had been suggested by some observers.

Singh (1990) in examining performance in the first three years before entry to a stock market found that buy-outs tended to outperform their corresponding industry averages in terms of revenue growth, inventory management, operating income and debtors. Buy-outs of former divisions of larger groups tended in particular to grow faster than industry averages whilst maintaining the same levels of operating income. Inventory management and accounts receivable register substantially favourable levels of improvement over time than the industrial average and indeed over a remarkably short period suggesting that managers make radical changes in the operations of their firms to achieve these benefits.

Kaplan (1989) looking at 76 going private buy-outs between 1980 and 1986 noted that in the three years after buy-out, they experienced increases in operating income (before depreciation), decreases in capital expenditure and increases in net cash flow. Changes in the ratio of operating income to assets and to sales (which helped control for divestiture and acquisitions) exceeded the industry average changes by 20 percent in the first three post buy-out years. Operating changes were seen to be due to improved incentives rather than lay-offs or managerial exploitation of shareholders through inside information.

Including 35 companies used in the Kaplan study in the sample, Smith (1990) examined operating returns as measured by operating cash flow before interest and taxes, deflated by operating assets

and the number of employees. Before and after adjustment for industry trends increase from the year preceding to the year following completion of the buy-out. Subsequent changes in the operating returns suggest that the increase observed in the first year is maintained with adjustments in the management of working capital contributing to the increase in operating returns. Like Kaplan, Smith concludes that the increase in operating returns after buy-out most likely reflects an increase in operating efficiency stemming from improved management incentives.

Muscarella and Vetsuypens (1990) in looking at 72 firms which went public since 1983 but previously had been subject to a divisional or going private LBO noted that the companies appeared to have undertaken numerous restructuring activities designed to increase the efficiency of the firm's operations. These 'reverse' LBOs had experienced significant improvements in profitability when compared with random samples of publicly traded firms over similar time periods resulting from the sample's ability to reduce costs rather than to generate more revenues or improve asset turnover. The efficiency gains were independent of acquisition or divestment activity after the LBO and were more pronounced for those which had been a divestment rather than a going private LBO. While firms on average reduced their relative capital expenditures, they did not implement reductions in employment. However over two fifths had divested some assets or had re-organised production facilities.

Scherer (1986) undertook a series of case studies of buy-outs on divestiture. He found evidence of important improvements, including a reduction of delays and distortions in decision-making and resource utilization. However, he expressed concern that over-strict financial control could jeopardise advertising and R & D budgets. Direct evidence on this point is hard to come by. Lichtenberg and Siegel (1989) found no evidence that manufacturing firms which have undergone an ownership change reduce their R & D spending although they confirm the findings of previous studies that LBO targets are much less R & D intensive than other firms. Smith (1990) also found no support for the assertion that pervasive cutbacks in discretionary expenditures such as R & D,

advertising, and maintenance and repairs are responsible for the short run increases in operating cash flows. Opler (1992) found that while leveraged buy-outs were followed by substantial increases in operating and net cash flow, both capital expenditure and R & D expenditure declined after the buy-outs were completed. KKR (1989) noted increases of an average 15 percent in R and D expenditure after LBO in a sample of 15 companies although they noted that the companies most appropriate for buy-out generally had well-established products and were not in the high technology and hence did not require large-scale research and development to remain competitive. Long and Ravenscraft (1989) noted that the KKR study had not controlled for industry effects. However, a small sample study by the National Science Foundation, reviewed by Yago (1989b, Chapter 9) reported lower growth rates in R & D for LBO firms. However Yago (1989b, Chapter 5) with a different sample noted that the rate of capital spending among companies which had issued high yield securities ('junk' bonds) was more than twice the industry total while Pound and Gordon (1989) found that high yield issues increased capital spending generally and by more than was expected at the time these debt securities were issued. More generally, it is unlikely that any reduction in research spending will be substantial since American LBO activity is overwhelmingly concentrated in low R & D intensity industries (Hall 1989). However Hill and Snell (1988) showed that research intensity increases in firms where an owner's perspective dominates. Welch and Bolster (1992) note that in hostile takeovers long term spending on R & D rises significantly in the post merger environment.

Lichtenberg and Siegel (1990) in comparing the effect of total factor productivity of buy-outs with over 12,000 manufacturing plants concluded that LBO's and particularly MBO's completed in the period 1983-86 had a strong positive effect on Total Factor Productivity in the first three post buy-out years: plant productivity increased from 2.0 percent above industry mean in the three pre buy-out years to 8.3 percent above industry mean in the three post buy-out years. However, buy-outs completed in 1981 and 1982 had no significant productivity effect.

Bull (1989) came to a similar conclusion finding that the financial performance of 25 sample companies for two years after buy-out was superior to that during the two years before buy-out in terms of both their own performance and in comparison with industry averages. Bull considered that although there was some support for the agency cost reduction argument for improved buy-out performance, the evidence was convincing that major improvements came from the change to management focus, apparently from minimising variability in reported profits to maximising cash flow. The improvement was greater than for income tax savings alone. Malone (1989) examining early characteristics of 56 smaller company leveraged buy-outs as well as the characteristics of the individuals undertaking the buy-outs, noted that they did not seem to rely heavily on selling off assets or laying off employees. Instead the dominant changes lay in the area of increased marketing and revenue enhancement.

The possibility has also been examined that a substantial proportion of gains may have been derived from tax savings resulting from interest payment deductibility and higher depreciation allowances when assets are stepped up (Lowenstein 1985, Kaplan 1989, Bull 1989, Leland 1989, Schipper and Smith 1992). While a positive correlation between premium and potential tax savings has also been established (Kaplan 1989, Marais, Schipper and Smith 1989) Kaplan maintained that the tax benefits largely went to the pre-LBO stockholders, the post LBO equity holders only getting the benefits of efficiency improvement and it does not appear that tax benefits are the sole driving force of buy-out opportunities. Newbould, Chatfield and Anderson (1992) in examining 23 of the largest buy-outs since the 1986 Tax Reform Act concluded that appropriately structured leveraged buy-outs still create significant tax incentives. However, on average, since 1986 less than half the buy-out premium can be attributed to reduction in taxes. However the role which taxes play in the buy-out process are likely to be highly complex (eg Long and Ravenscraft 1989, Wright, Normand and Robbie 1990) while the US tax system provides substantial incentives for the excessive use of debt in the context of corporate restructurings (Summers 1989) with firms likely to pay less taxes in the first years after going private (Opler 1992). Haynes (1989) shows

that the use of tax shields, that would not be fully utilised in the absence of an acquisition, is significant in explaining the gains to target firms' shareholders as well as to the acquiring firms. However tax saving in a buy-out must be seen in the overall fiscal context. Jensen, Kaplan and Stiglin (1989) argue that the net effect of buy-outs is to increase the present value of (US) Treasury tax revenues by 61 percent after taking account of taxes on capital gains realised by the pre-buy-out shareholders; taxes on operating cash flow increases from buy-out; taxes on interest income received by buy-out lenders; and taxes on the capital gains from post buy-out asset sales.

(b) UK and European Performance Studies

Given the relatively small number of going private buy-outs in the UK compared to the US (Chiplin, Wright, Robbie 1992), research in the UK has had a different focus to that in the US. Additionally the more recent time period has meant that most published research has been carried out during a period of favourable economic growth with little opportunity for long-run accounting and financial data analysis.

Across all buy-out in the UK, a study of the initial consequences of buy-out for 111 private sector cases up to mid-1983, a period largely characterised by recession, showed improvements in profitability, trading relationships, customer bases, cash and credit control systems and evidence of new product development. The sample showed considerable changes in employment and management structure (Wright and Coyne 1985). These findings are supported by a second survey of 57 buy-outs over the same period undertaken by Hanney (1986) which noted that in terms on initial performance (as measured by pre tax profits) 80.7 percent of the sample surveyed showed improvements in the first year compared to pre-buy-out levels. A subsequent survey by CMBOR of 182 UK buy-outs completed between mid-1983 and early 1986, a period of industrial recovery, lent support to these earlier studies, but also found certain differences. For the majority of respondents, trading profits and turnover were found to be "better" or "substantially better" than before the buy-out and in excess of expectations contained in the business plan (Thompson,

Wright and Robbie, 1989). However the lack of accounting data in these surveys clearly influences the worth that can be derived from these findings.

Jones (1992) noted that improvements in operating efficiency in the first two years following buy-out were achieved by modifying organisational structures and the attitudes of participants, these modifications being interrelated with the adoption of more appropriate accounting control systems.

While the above UK studies confirm short term improvements in corporate performance, there are major questions to be resolved as to the long term nature of these improvements (Houlden and Brookes 1989, Bannock 1990a, Jones 1992). Analysis is clearly complicated by the effects of exits among the high performers/ fast growers on the average performance of those which remain with their original buy-out structure (Wright, Thompson, Robbie, Wong 1993).

A study of the longer term performance of buy-outs in the UK using operating performance data, confirmed that in the short-term buy-outs outperformed averages in terms of return on capital employed and returns on sales but found that after three years there was a reversal of the better-than-industry performance but with considerable variation between sectors (Houlden and Brookes 1989). However, this study has to be treated with care as the longer-term results are based on samples in single figures and in some cases with incomplete accounting records, the ratio of non-exiting to exiting buy-outs within the sample was a serious distortion compared to the characteristics of the overall population of UK buy-outs.

A later survey by Bannock (1990a) using accounting information provided by 3i on their buy-out investments concluded that average rates of return on assets for all 3i MBOs was above that for 3i investee companies as a whole and both groups had shown better returns than average for all large UK companies. When measured over several years from buy-out, average rates of return on

assets of 3i buy-outs fell initially and then fluctuate about a rising trend which continues until at least Year 4. The available data did not allow firm conclusions beyond this period. In a complementary questionnaire survey of 366 3i buy-out managers, 37 percent reported substantially increased profits since the buy-out, 29 percent moderate increases and 16 percent a fall in profitability. This improved performance had not generally been achieved by cutting back on investment, R and D spending or marketing. Clearly these results have to be tempered by the bias which may exist in the use of data which was drawn from only one venture capital firm and reflect performance at a relatively favourable point of the economic cycle.

Kitching (1989) in a survey of 110 US and UK buy-outs noted that while buy-outs made impressive efficiency gains, US buy-outs often failed to meet forecasts made to investors and lenders. The average US LBO delivered 80 percent of forecast EBIT in year one, 98 percent in year two, 92 percent in year three and 75 percent in year four. The average UK buy-out in contrast exceeded forecast EBIT in year one and then delivered between 95 and 100 percent of the forecast in later years. Kaplan (1989) similarly noted that post buy-out operating performance in the first two years after buy-out was below the projections provided by managers in the buy-out proxy statement. Kitching also remarked on major changes in capital management. Inventories went down significantly in more than 50 percent of the buy-outs, while creditors payable went up in more than 40 percent of the sample. 70 percent did a sale and leaseback of some fixed assets while 30 percent of the UK buy-outs in the sample acquired new companies or divisions.

Continental European evidence on the performance effects of buy-outs is as yet limited as the markets have until recently been undeveloped. In the Netherlands, evidence suggests that for buy-outs completed up to 1985, 53% increased market share with a similar proportion achieving growth in return on assets. In only one tenth of cases were falls in profitability recorded. About two thirds claimed to be much more viable, mainly because of increased flexibility to act in the

market place, and greater internal flexibility and control (Dutch National Investment Bank, 1985).

Another study of Dutch buy-outs shows an encouraging picture, even in the longer term (Bruining, 1992). The main financial ratios of medium sized and large management buy-outs relating to cash flow, sales and return on investment were significantly better than the average financial ratios of the industries involved over periods of up to seven years during 1980-90 with strong indications that total agency costs had been reduced.

In France, a study of the initial performance of fifty buy-outs completed under the government sponsored scheme to encourage this form of ownership transfer, provided indications that growth rates and profitability were significantly above the levels prevailing prior to the management takeover (Binz, et.al., 1985). A subsequent survey by CEGOS (1990) of publicly reported buy-outs in France recorded substantial post buy-out improvements in turnover (an average of thirteen per cent per annum), net profit (an average twenty one per cent increase) and employment (an average five per cent increase). In relying on publicly reported transactions, this study possibly included a much greater proportion of divestment buy-outs than is believed to be the case for the French market as a whole and may therefore not portray a comprehensive picture of post buy-out performance changes.

Studies of UK buy-outs which have exited by flotation on a stock market show that performance as measured by increases in company value exceeds market indices both prior to flotation (Thompson, Wright, Robbie, 1992) and afterwards (Lloyd et al, 1987; Parker, 1988; Wright, Robbie and Coyne, 1987), although post flotation performance tended to slow down. Attwood, Donald and Eagles (1992) in examining management buy-outs which had floated on the London Stock Market whose market capitalisation exceeded £40 mn at flotation subsequently outperformed the FTA All Share Index for the first three years despite the first day of issue

premium being only 4.7 percent relative to the Index. Longer term performance also showed outperformance, although at a more moderate pace.

(c) Management Equity Stakes

The crucial question as to whether greater managerial equity stakes lead to higher levels of performance has attracted a great deal of general attention beyond management buy-outs. A major study of chief executive incentives and company performance concluded that "what really matters is the percentage of the company's outstanding shares the Chief Executive Officer owns" (Jensen and Murphy, 1990). In the case of management buy-outs, because management owns a substantial part of the firm, the separation between ownership and control has been reduced (Fox and Marcus 1992). The larger the managers' ownership position the more control they have (Frederickson & Iaquinto 1989, Stultz 1988) while the more they tended to identify their interests with the interests of the owners (Morck, Shliefer and Vishny 1988b).

Whilst, as reviewed above, evidence concerning performance improvements in buy-outs appears strongly positive, it has not been clear what has contributed most to the changes which occur. It can be argued that the size of the management equity stake is the most important factor in explaining improvements in performance after buy-out (Thompson, Wright and Robbie, 1992). From an examination of twenty eight buy-outs which had floated on the stock market, it was found that the amount by which the uplift in the value of the bought out company between buy-out and flotation exceeded the risk adjusted market return over the same period (the "excess return") was greater the larger was management's equity stake, after controlling for size, industry, etc. The control devices such as equity ratchets and high levels of debt, were generally insignificantly related to increases in company value. The results of this study imply that a ten per cent increase in management equity ownership for firms in the sample, would increase the excess returns to total capital by approximately 25 per cent.

(d) Employment Considerations

A more controversial performance issue concerns the impact of buy-outs on labour. In the USA, where the highly leveraged deals might be expected to create redundancy, the evidence is unclear. Jensen (1989) reports that employment increased 4.9% among a sample of LBOs, but fell 6.2% after adjustment for industry factors. (Although making such an adjustment is itself problematical when many LBOs are conglomerates and job losses are frequently concentrated at their corporate headquarters). Both KKR and Forstmann Little, two leading LBO specialists, suggest that overall employment has increased among their clients. Yago (1989a) examined profiles for the cohorts of LBOs occurring in each of the years 1984, 1985 and 1986. In the first two cases there was an overall improvement in employment performance and in the latter year a worsening. Yago suggests that there is an initial shake-out, associated with reorganisation, followed by subsequent repositioning of the firm and new recruitment. Kaplan (1989), found a positive median change in employment of 0.9 percent with an employment increase in half the companies. Adjusting for post buy-out acquisitions and divestiture produced a more positive result. 61.5 percent of these companies increased employment with a median increase of 4.9 percent. Muscarella and Vetsuypens (1989) found a slight decline. After adjusting for industry factors, Kaplan found that relative employment declined sharply. A clearer picture is provided by Smith (1990), who after allowing for the decline which may result from asset sales, found that although sample firms did not tend to reduce the number of employees after buy-out, they tended to hire fewer new employees than other firms in the same industry. Yago (1989b) reports that LBO firms have a slightly lower incidence of closure than other manufacturing plants. This result supports the finding of substantial productivity improvements following LBOs. Lichtenberg and Siegel (1990) report no significant post buy-out reduction in the number of blue collar employees although there was a decline in non-production employment. In addition they report a significant increase in the average annual compensation levels of production workers from one year before the buy-out to two years afterwards.

Analysis has also been carried out of trends in employee majority owned firms including those with ESOPs (Robinson and Wilson 1992) although there are doubts as to the statistical significance of certain studies. Rosen & Klein (1983) found employment growing 2.78 percent faster in employee owned than in conventional firms and by 3.87 percent for ESOPs alone. Trachman (1985) noted that companies that had share ownership with over 51 percent of employees, had employment growth 2.4 times higher than non-employee ownership companies. Quarrey (1986) deduced that generally ESOPs improve employment growth by 3.8 percent per annum.

In the UK there appears to have been a marked reduction in the 1980s in the proportion of buy-outs shedding labour, which is related to a shift away from distress sales to management and to the general recovery in profitability. In the earlier survey by Wright and Coyne (1985), 44% of firms reduced employment whereas in the later CMBOR study this had fallen to 25% (Wright, Chiplin, Thompson and Robbie, 1990a). The CMBOR survey also showed an improved position in terms of job losses, 18% of pre buy-out jobs in the earlier survey having been found to have been lost on the transfer of ownership, but only 6 % in the later study. The Wright and Coyne survey also found, however, that after buy-out there had been some recovery in employment levels, but not to the levels prevailing prior to the transfer of ownership. At the time of the CMBOR survey, total employment was some 4.5% below pre buy-outs levels, and 2% above the level immediately after buy-out. 78 percent of Bannock's (1990a) survey of 3i backed buy-outs maintained or increased employment after buy-out. The UK firms, being generally smaller than their US counterparts, are clearly less affected by sell-offs of assets.

2.6.3 Turnaround, Action and Problem Areas

Discussion of performance studies has implied that management buy-outs frequently involve companies where there may have been some relative under performance in the past; the implications of the new ownership structure have allowed Teams to produce at least in the short

and medium term meaningful performance improvements. However in some cases and especially in management buy-ins a more fundamental turnaround may be required. Turnaround once triggered will involve identification of the underlying problems of the company followed by specific actions to reverse these. Issues relate to the identification of problems (see 2.2.6), the phases of action required and the type which is relevant. There may be considerable variations between individual transactions with particular problem areas emerging in some cases.

While Gopinath (1991), Robbins and Pearce (1992), Hoffman (1989) and Zimmermann (1991) have all referred to the stages required in turnarounds, their application can be broadly seen as follows. After the identification of need for turnaround and action two phases can be broadly established, the first involving immediate retrenchment and stabilisation which will then be followed by a period of recovery. During these two phases necessary actions will differ: in the first concentration is on survival, stopping performance decline and ensuring a significant improvement in cash flow. This may involve asset reductions, and cost reductions including liquidation, divestment, product rationalisation and employment reductions. Upon stabilisation the recovery phase involves a recovery strategy which matches the blend of causes of the decline with entrepreneurial dominant strategies. This will aim for the long term profitability of the company and growth in the market and strategically will involve market penetration, reconcentration/segmentation, new markets, acquisitions and new products. Consequently over the two periods a mixture of both defensive (ie halt deterioration) and offensive (improve performance) activities are likely to be employed.

Turnaround may also be seen as either operating or strategic (see eg Schendel, Patten & Riggs 1975, Hofer 1980, Robbins and Pearce 1992) with operating reasons prompting operating remedies and strategic ills resulting in strategic remedies. In operating turnaround the financially troubled firm pursues its current strategy more efficiently, typically controlling costs more effectively, more efficient utilisation (including some reduction) of assets, increasing revenue

(through regaining lost position rather than increased market penetration) and improvements to production processes and their associated managerial and structural changes. Strategic turnaround in which emphasis on strategic change is sought, sometimes referred to as entrepreneurial turnround, involves the financially troubled firm pursuing a return-to-growth strategy and consists of manipulating strategy components, such as reposturing the firm's product or services, its primary markets, principal technologies, distinctive competencies, competitive advantages, and strategic alliances.

Classification into these categories may however be misleading given the practical and political factors present in seeking to reorganise companies and variations in both causes of decline and characteristics of the company. Reality may be that strategies have to be adopted which combine both operating and strategic aspects, sometimes depending on how widespread the problem areas are within the overall firm. Such possibilities are only given limited significance in some of the literature, eg Hofer (1980), although there are some, eg Hambrick and Schecter (1983), suggesting that strategic turnarounds are unrealistic for most mature businesses and illustrate three main types of successful turnarounds: those involving asset/cost surgery (associated with companies with low levels of capacity utilisation); selective product/market pruning (companies with high levels of capacity utilisation) and piecemeal (companies with high market share).

Factors which will facilitate turnaround require to be aimed at the underlying causes of the need for turnaround described in 2.2.6 and have been examined in a variety of studies (eg Slatter 1984, Grinyer et al 1988, Zimmermann 1989, 1991) and can be categorised into similar groups.

Illustration of the possible types of actions are shown in Figure 2.3. Management and especially CEO change, the most important element in analytical studies, is described in more detail in 5.3.

FIGURE 2.3: TYPICAL TURNAROUND ACTIONS	
Factor	**Type of Action**
Management	New Chief Executive and or Chairman; changes in Executive Directors; improvements to quality of management; new values and vision; improvements to motivation and incentives; encouragement of entrepreneurial behaviour; improved communications
Financial (internal)	Stronger controls especially of cash flow, working capital, capital expenditure, budget variances; tightening of credit, debtor, stock and other financial ratios; overhead control; improvements to internal reporting systems and better quality of information circulated to relevant personnel; changes to budgetary and longer term financial planning
Financial (external)	Action to limit damage from external events, eg capping, hedging. May be helped by currency depreciation or unexpected favourable movement in interest rates
Cost Structure	Re-organisation of production systems to reduce cost; tighter control of overheads including head office related staff; reduction in working capital costs; material and energy cost reduced; introduction of cost saving technology; efforts to take advantage of economies of scale
Market Demand	Windfall, effects of cyclical, secular upturn in demand; positive effects of government actions; exit of competitor
Production and Labour	Reduction of production costs; investment in new plant; programme to improve employee morale; improved utilisation of existing capacity; changes to production and stock control; introduction of wage inventive systems; use of work study; improvements in labour productivity
Marketing	Efforts to get closer to the customer; changes to distribution channels; rationalisation of product range; possible extension or diversification within product range; improved market research; more cost effective advertising; more appropriate pricing structure-discounts; identification of new, eg export, markets; improvements to after sales service
Competitors	Use of marketing, cost and pricing measures to be significantly more competitive than before
Acquisitions, Divestment and Big Projects	Closure or sale of heavily loss making subsidiaries; sale of weaker companies with no long term position in the group; avoidance of large prestige projects which may increase risk profile of company excessively; possible use of funds raised through disposals to re-invest in areas to secure diversification, supplies and distribution channels

Internal financial measures will include significantly tighter controls of areas such as inventories and debtors, the exercising of longer periods of credit to reduce working capital requirements, more emphasis on cash flow, control of overhead and variable costs, greater scrutiny of fixed

capital expenditure, new budgeting procedures, the use of new financial ratios and an improvement in the quality of financial information available to management. Preventative measures may be taken to reduce exposure to financial movements which may be external to the company- eg interest rate and currency hedging. As part of the emphasis on cash generation non-core subsidiaries and other surplus assets may be sold with others which are being retained subject to sale and leaseback arrangements.

A more detailed, although small sample, study of the short term changes in accounting control systems following a buy-out provides evidence that the remarriage of ownership and control involved enables more appropriate systems to be introduced, especially at the more strategic level (Jones, 1992). There is also evidence of a perpetuation of standard performance reports, influenced to a great extent by the requirements of financial backers who wished to ensure that buy-outs were effectively controlled in order to meet their finance servicing costs. In addition, there was a weak association between environmental factors and changes to accounting systems after the buy-out. Rather, there was a strong influence of managerial choice as to the most appropriate techniques to make best use of the human and capital resources available. There was clear evidence that whilst management were freed from group constraints, and had the ownership incentive to make improvements, the bonding to meet financial targets was also a key influence on the action they took.

Efforts will be made to reduce the cost structure of the company. This will include tight control of overheads, the cutting of head office wastage and staff, the spin-offs from the interest cost effects of the reduction in working capital requirements, stricter control of energy, material and production costs, the introduction of cost saving technology and efforts to improve economies of scale.

Considerable attention will also be placed on marketing. This will include not only areas such as revision of advertising arrangements, distribution channels, but examination of new markets, including exports. Pricing levels and discount structures will be analysed. Market research may be increased and the level of marketing information within the firm increased. The firm may be affected beneficially by external factors such as cyclical and sectoral upturns in demand, government action or the exit of a competitor.

Allied to this emphasis on marketing, the product range will be examined, perhaps rationalised but it could also be subject to diversification or extension. New designs may be introduced and efforts made to increase quality, availability and after sales service.

Major changes will also be implemented in production and labour as part of the action to reduce production costs and improve build quality. Efforts will be made to improve employee morale, increase the utilisation of existing capacity and raise labour productivity. Wage incentive systems may be introduced and work study schemes examined. Production and stock control systems will be updated.

Depending on the extent of the turnaround crisis and the success of cash generation activities the firm may engage in acquisition activity although this is likely to be financed by disposal of non core and peripheral activities. Profitable core businesses may be expanded while weaker ones may be sold. Product diversification may also be engaged in subject to maintaining a moderate risk stance

Case study evidence from the US (Scherer, 1986), shows benefits from the removal of delays and distortions in decision-making and the draining away of resources to other parts of a larger organisation. However while the primary motivation behind such divestitures may be to improve competitive position, enhance managerial efficiency and enhance the firm's economic value in

capital markets, improvements may not always be so apparent in the performance of the unit or division being divested (Woo, Willard and Beckstead 1989).

Attention also will be paid to the relationship with the vendor. While the purchase agreement will have included a legalistic arrangement to cover elements of the sale (eg warranties), important continuing trading relationships may also have been covered making the separation between parent and subsidiary neither immediate nor complete. These may involve sales or purchases of goods and services or both and include minimum purchase elements. Attempts are made to spread the base of trading partners and reduce parental dependence soon after buy-out (Wright and Coyne 1985, Wright, Chiplin, Thompson, Robbie 1990b). Additionally the vendor may in certain circumstances retain an equity stake. Group structure constraints may require rapid changes to enhance product ranges to meet market conditions, more appropriate managerial control systems and organisational structures and enhanced investment while important changes may be necessary to develop products and customer bases.

In management buy-ins a major issue also relates to the distortion which may occur through the discovery of problems which were not identified in due diligence procedures.

2.6.4 The Role of New Management

Through the introduction of new management, the backers of buy-ins are hoping to inject new vision and strategy for the target company which will be superior to that in the pre-acquisition structure. Issues emerge as to the role of management in any decline prior to the buy-in, the comparative abilities of new top management and Chief Executives and the contribution which new management can make.

Agency theory has shown that over time the separation of management and control may lead to lack of control of managers and hence poor performance, relatively weak share prices and

increasing the probability of agreed or hostile takeover. The eventual reaction by shareholders and sometimes banks may include either a decision to sell the company or parts of it at this stage or alternatively to replace incumbent management. Evidence for the former reaction has been shown in 2.3.4 and for the latter in studies such as Grinyer et al, 1988, McEachran 1977, Coughlan and Schmidt 1985 and Warner, Watts and Wruck 1988 with high rates of executive turnover also being noted in the extreme cases of companies going into bankruptcy (Ang and Chua (1981), Schwartz and Menon (1985) and Gilson (1989)). There is evidence that the type of functional managerial experience may make it possible to differentiate between companies which went bankrupt and those which did not in the same sector (Hambrick and D'Aveni 1985). At the same time executives who feel that under-performance is not related to their own abilities and actions within the firm may leave for reasons such as to protect their reputation. In so doing they may further worsen the performance of the company but also enter into the realm of the effectively displaced manager who could seek a more entrepreneurial role through a buy-in.

Replacement of management may be by internal appointments or external recruitment although in practice both forms are used (eg Slatter 1984 Grinyer et al 1988). A major issue is whether external recruitment will result in superior performance. Strong arguments can be made, eg Bibeault (1982) and Hofer (1980), that it is very difficult for internal management to produce turnaround as successfully as those recruited from outside. These are based on current management having such a strong set of beliefs about how to run the business that many must be wrong for the company's problems to have occurred in the first place. Replacing management stimulates change through unfreezing existing attitudes, removing concentrations of power, providing new values and vision for the company, introducing new methods for solving particular problems, and creating the levels of stress or tension needed to stimulate organisational change and more innovative and entrepreneurial behaviour throughout management (eg Hoffman 1989). Nevertheless some US studies (eg Dalton and Kesner 1985, Warner, Watts and Wruck 1988, and Furtado and Karan 1989) have not been able to support this view. One reason may be the danger

that the introduction of new management may in the short term produce resentment from remaining management which depresses performance.

The issue can be seen as critical in the success profile of management buy-ins where external management are clearly assumed to be able to be more capable than an incumbent management team. The latter may have been in possession of insider information of both upwards and downwards potential. Knowledge of this, which may be denied to the external management team, may have major implications for the type of skills which are required to effect turnaround and performance improvement.

Once problems have been identified Hofer (1980) has seen the strategist/entrepreneur as suitable for high growth-strategic turnarounds. The hard nosed experienced cost cutter would be more appropriate for operating turnaround with a major cost reduction effort to be pursued. Zimmermann (1991) notes the importance of coming from the same industry with the executive needing to know the particular processes, competition, suppliers, customers or individual people within the industry while the new Chief Executive needs to articulate ideas, purposes and procedures using unambiguous language, honesty and trustworthiness and have the ability to share success with the rest of a team which is well rounded in terms of overall experience and knowledge. Hambrick and Mason (1984) have noted that it is potentially possible to explain significant performance in terms of the 'upper echelon'- age related, functional experience, corporate influences, education, socio-economic background and group heterogeneity. Norburn (1986) in examining Top Managers in the large UK companies remarked that top management characteristics differ significantly within industry sectors of growth, turbulence and decline. Norburn and Birley (1988) also noted top management teams who demonstrate multiple company employment and wider education training will out perform those who do not, whether this be based upon criterion of inter or intra industry productivity.

Developing the reasons seen for need for turnaround and identified in 2.6.3, management are therefore likely, depending on the severity of the crisis facing the target company, to introduce a series of measures which will cover the areas outlined in Figure 2.3: further changes to management who will be made fully aware of the new vision and strategy being applied; financial actions aimed at both internal and external considerations; pruning of the cost structure; production re-organisation and labour; marketing action; competition and a programme of disposals possibly followed by selective acquisitions. External management and new ownership of the company are likely to result in a more radical restructuring than other combination such as new management but existing ownership.

2.6.5 The New Type of Governance

To ensure that performance is achieved and associated with the new financial structures implied in buy-outs and buy-ins are improved governance systems involving new methods of monitoring and control by the financial investors in the target company. In the UK venture capital firms are distinctive in the way they make and control investments; similarly in the US LBO Associations have been seen by Jensen (1989a) as representing a new organisational form which may offer greater efficiency than conglomerate organisations and introduce a further means by which the performance of large under-performing companies can be improved.

Typically LBO associations and venture capital firms are generally run by partnerships with small staff levels instead of the headquarters office in the typical large, multi-business diversified corporation where staffing may be in the hundreds or thousands (see eg Sahlman 1990). They take an important role in the strategic direction of each LBO in which they are involved and hold significant amounts of its debt and equity. The partnership's executives as well as the heads of each business unit also have substantial equity interests which are in general far larger than might be expected for executives in a large corporation. Additionally the control functions of debt places pressure on managers to consider carefully the spread of activities in which they should be

engaged. Unlike the diversified firm where cross subsidisation of subsidiaries is possible, the LBO partnership is unable to transfer resources from one LBO business to another.

The typical UK quoted company can be seen as consisting of several layers of control with shareholders possessing only indirect control; management are likely only to have minimal shareholdings, perhaps only as part of a long term executive share ownership plan. There is likely to be a group headquarters as well as divisional boards having their own HQ although these may be located at operational units. Beneath these there will be operating companies within the Division usually with their own Board. With local board meetings being held perhaps only on a bimonthly basis, there can be a significant time lag between a problem developing and action being taken by the parent board. In contrast Buy-out and Venture Capital partnerships will have raised funds through a limited partnership agreement (Figure 2.4). The Partnership HQ will be a small unit which will hold weekly investment meetings which will also discuss problems which may have arisen through their monitoring control processes. The Partners will themselves be motivated to perform through incentive arrangements in the Limited Partnership Fund agreement and direct and indirect holdings in the equity of the investee companies.

The degree to which a venture capital partner becomes an active or 'hands on' participant in the invested business (van Wakeren et al. 1990, Sapienza 1992), is a function of the importance of the investment, the existing management capabilities of the investee firm's team and the 'style' of the venture capitalist. MacMillan, Kuwlow and Khoylian (1988) identified three layers of involvement: 'laissez-faire'; moderate; and 'close tracker', although they are frequently categorised as either 'hands off' or 'hands on'. 'Hands-off' investors may be content to remain relatively remote from the operation of the investment requiring only period reporting of key financial and operational data and not necessarily taking up directorship entitlements. Others adopt a much more proactive 'hands on' role appointing their own executives or nominee external managers as non-executive directors to the boards of the investee businesses. They become involved in

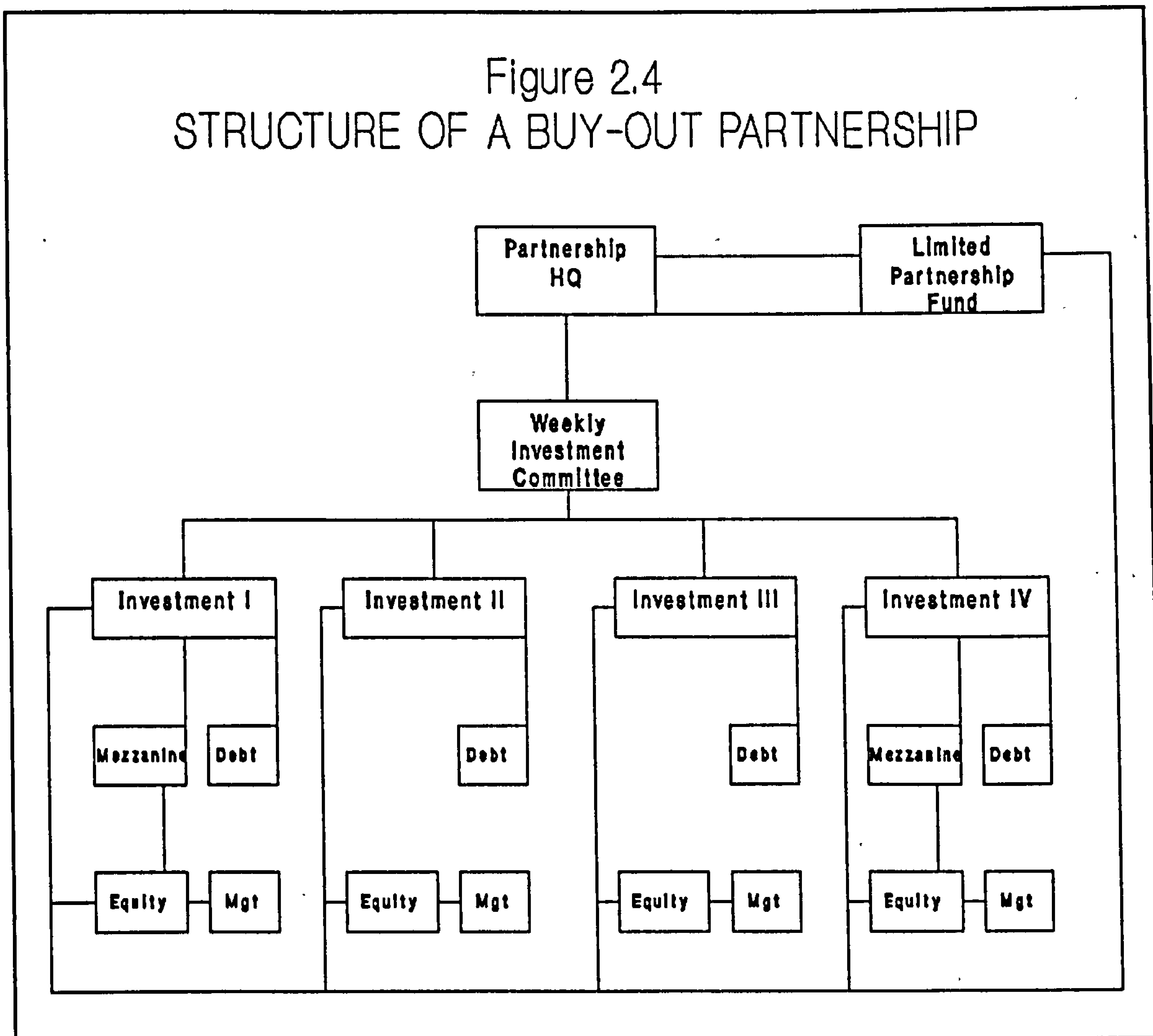


Figure 2.4
STRUCTURE OF A BUY-OUT PARTNERSHIP

operational details including strategy formulation, future finance raising, new customer and supplier contact, recruitment of key staff and realisation strategy (Sapienza and Timmons 1989). In particularly difficult circumstances, eg when a serious skills gap has developed or where there have been unexpected and adverse trading conditions, the venture capitalist may become intrusive in the running of investee companies irrespective of strategy preferences (Murray 1991a) including seconding their own staff for an extended period to the investee company.

2.6.6 The Life Cycle and Methods of Realisation

The need for this style of governance structure has to be seen in the context of planning and controlling for the longer term aspirations for the firm by both investors and Team. Venture capitalists need to achieve investment goals set by the providers of their funds. This will differ

significantly between different investors, some preferring to realise relatively early capital gain others emphasising a running yield on their investments through dividend payments (Robbie and Wright 1992c, Ascott and Chotai 1992). Management may also be motivated by financial gain or be happy to remain independent but require to plan succession to younger colleagues or family. The firm itself may require more diversified funding for expansion either through an IPO or as part of a larger group. Consequently a series of changes involving whole or partial realisation of buy-outs can be expected, occurring over different time periods.

The large variety of venture capital institutions allows for a significant variety in approach to the financing arrangements for buy-out terms. Clear differences can be expected between those institutions seeking short to medium term capital gain compared with others structuring deals to obtain a significant yield on their investments but prepared to take a capital gain in the long term, see Dixon (1991). Additionally the whole relationship with venture capitalists and to some extent banks involve a series of mechanistic devices (eg covenants based on financial ratios, board representation, production of regular accounts, approvals for capital expenditure above particular levels as well as ratchet mechanisms to vary management's equity stake dependent on pre-defined targets including exit) thereby providing a range of flexible techniques for adapting the buy-out to differing circumstances (eg Robbie and Wright, 1990a, Green and Berry 1991 and Campbell, Beckhhofer and McCrone, 1992). Such structures reflect those of venture capital investments generally (Sweeting 1991, MacMillan et al 1989 and Sahlman 1990), the last comparing and contrasting the control mechanisms in LBO organisations and venture capital funds. Case study interview evidence suggests that in achieving exit, institutions extensively utilise flexible control processes which enable them to be both proactive and respond to changing circumstances (Wright, Robbie, Romanet et al 1992)

Management clearly will also be a very important influence given that they have generally perceived the entrepreneurial activity in the first place (Bull 1989, Wright Thompson Robbie

1994). However the actual size of initial equity stake especially in the larger buy-outs may limit the control which management may have over the form of realisation with institutions more able to control the exit. With a work force which is relatively stable in size and with little staff turnover, there is also the possibility that the internal share market of an employee buy-out may run out of sufficient liquidity to operate effectively (Ben-Ner 1988).

Differences in motivation of managers (eg reacting to a one-off opportunity v a more proactive recognition of a chance to implement one's own growth strategy (Wright, Robbie, Thompson, Starkey 1992) may also influence longevity. If management have highly specific non-transferable skills, they may have little option to remain with the financiers into the long term; evidence from buy-outs suggests widespread long term commitment to the firm (Wright and Coyne 1985).

Several important factors have to be recognised. These include the overwhelming importance of the buy-in or buy-out in the management's personal asset portfolio compared to the less significant importance in that of the backing financial institution(s); desire by management to remain independent which may be at variance with an institution's wish to realise capital gain; emotive ties to the business by management (especially in a buy-out) as opposed to a more detached view of the financier; and the asymmetry of information between the parties as a result of which management may have a better idea of the actual and potential performance of the business than a financier although financiers will have greater experience in financial markets and may be better placed to have a fuller picture of the range of financial and strategic options available to the firm (Wright, Thompson, Chiplin, Robbie 1991).

The initial financial structure of a buy-out will attempt to reconcile these differences and prepare for the eventual realisation of the interests of both managers and venture capital investors. Whilst realisation is necessary to enable the interested parties to meet their objectives, it is also linked to the different financial and ownership needs of the firm itself at different points in its life-cycle.

This point is not unique to buy-outs; all venture capital investments as well as other firms experience a life-cycle in which different ownership and financial structures are appropriate (Mueller, 1988, Jones and Butler 1992). Discussion of exit and realisation may concentrate on the methods of realisation which are available, the governance of the buy-out or buy-in (see 2.6.5) and the life cycle of the company.

(b) The Life Cycle

Although there are various forms which realisation may take, a considerable debate has emerged concerning the longevity of the buy-out form and the relative extent to which these exits options are utilised. While management buy-outs have been seen to be only a 'honeymoon period' (Wright and Coyne 1985) or a transitory form (Rappaport 1990, Green and Berry 1991) and there have been concerns as to the longer term nature of buy-out control systems (Jones 1992), others have seen buy-outs as a longer term organisational form which may eclipse the public corporation (Jensen 1989). Indeed a large rump of venture capital investments do not manage to exit but remain in investors' portfolios beyond the original realisation target date (Ruhnka et al 1992).

Jensen (1989) argues that the advantages of LBO transactions from the point of the incentives to pay out free cash flow, the large equity stakes held by managers and the monitoring by the LBO sponsor imply that the public corporation is inferior as an organisational form to the LBO in low growth, mature businesses generating substantial free cash flow. Jensen feels that the superiority of this ownership form means that the LBO form is likely to last for a significant period. The need to retain a buy-out form for a significant period is also highlighted in terms of the advantages of the source of value which derives from the tax deductibility of interest payments (Kaplan 1989, Schipper and Smith, 1988). To maintain these benefits would imply the maintaining of the buy-out debt load or indeed re-leveraging the transaction when debt levels had become low.

Rappaport (1990) however disagrees seeing buy-outs as a transitory form arguing that the high levels of debt and concentrated ownership impose costs of inflexibility to competition and change. The need for investors to realise their investments to external suppliers of funds, the absence of a daily stock price to act as an objective measure of corporate value and restricted market applicability all restrict the long term nature of buy-outs. Shleiffer and Vishny (1991b) see many LBO controlled firms as temporary organisations designed to last only as long as it takes to sell off the pieces of the acquired firms to other public corporations: remaining pieces often offered to the public especially when their value has been enhanced by some operating changes. Green and Berry (1991) see management buy-outs as essentially a transitional state suited to recovery in shareholder value but not to long term strategic redirection or significant growth.

Kaplan (1991) notes that this argument could have included the need for managers, as their equity investment increases in value over the years, to reduce or diversify an otherwise increasing amount of undiversified risk by seeking some form of at least partial exit, eg through an IPO. Kaplan saw the Rappaport view as consistent with buy-outs being seen as 'shock therapy'- allowing management to focus on cash flow, foregoing unprofitable investment opportunities and selling unproductive assets, generally one-time events. In time the costs of inflexibility, illiquidity and risk-bearing will result in there being no advantage in the company retaining its unquoted status. Kaplan's examination of 183 large LBOs completed between 1979 and 1986 as at 1990 showed the majority (62 percent) still being privately owned with an unconditional estimate of the median time private of 6.8 years. Consequently Kaplan (1991) concludes that buy-outs are neither a transitory or permanent form, some following the Rappaport theory but a substantial proportion remaining independent for a long period as implied by Jensen (1989). Additionally those that remain independent retain debt levels similar to those at the LBO, ie the benefits of debt bonding remain. Wright, Thompson, Robbie and Wong (1993) noted in a UK sample that the majority of buy-outs (70.6 percent) remained privately owned seven years after buy-outs but that the greatest

increase in exit occurs in years 3 to 5 after buy-out. Nevertheless a significant minority do return to public ownership.

Major differences have been identified in UK buy-out exit patterns reflecting size distributions, the larger the buy-out the greater the probability of exit. Longevity may also be related to the original source of buy-out, those from privatisation or an overseas divestor having significantly different exit patterns than all buy-outs (Chiplin, Wright, Robbie, 1992). However this disparity may reflect the non-homogeneity of buy-out types and the identification of the specific elements of available governance structures and the differing contingent factors affecting buy-outs may provide some further explanation (Wright, Robbie, Starkey, Thompson 1994). This may involve differences of managerial, and financial and competitive and other market forces.

It may be that buy-outs have such different individual characteristics that varying patterns of realisation and longevity can be expected. For instance Williamson (1988) in providing an initial contingency approach argues that buy-outs with high leverage are most suitable for firms in mature sectors with significant free cash flow and or non-specific assets which can be sold off to pay down debt if necessary. In contrast buy-outs with lower amounts of leverage, higher incumbent management stakes and greater venture capital involvement in the provision of quasi-equity will be most suitable for buy-outs where free cash flow is relatively low, investment needs are relatively high, and assets are more specific. Lehn, Netter and Poulson (1990) find that LBOs occur in industries that are faced with slower growth prospects and R and D expense. Easterwood et al (1989) note that firm-level factors as well as industry factors are important. This is supported by Ambrose and Winters (1992) who found only statistically weak non parametric tests supporting an industry effect, concluding that there is a need to address firm specific factors (such as management or operating inefficiencies) in analysing buy-outs.

Furthermore the life cycle of buy-outs must be seen in relation to more general theories of the firm life cycle. The most important company related characteristics which are likely to influence the longevity of a given organsiational form concern rapidly changing markets, a fast growing company concentrating markets where it is necessary to have sufficiently large critical mass to survive and relatively high rates of merger activity (see eg Mueller 1988 for a review of the literature). The length and nature of life cycle stages varies considerably both between industries and between firms in different industries (eg Gort and Keppler 1982). While U.S. literature (eg Jensen 1991, Easterwood et al 1989, Hall 1989) has stressed the advantages of buy-outs in mature stable industries, UK and European experience (eg Chiplin et al 1992, Initiative Europe/CMBOR 1992) has been more varied allowing buy-outs to occur in less stable circumstances.

Even however when the particular circumstances of the sector and the firms within the industry have been considered, the initial buy-out structure may not be necessarily the best for medium and long term health of the company. For instance benefits from the buy-out may come quickly from removal of constraints on investment policies, new product developments, appropriate managerial structures imposed by private sector parents (Jones 1992, Wright and Coyne 1985, Singh 1990) and the greater degrees of such constraints in the case of former public sector divisions (Wright et al 1992). In the medium term new constraints may arise under the new ownership and some form of exit may be required to allow the company to develop and in some cases to survive (Green and Berry 1991). Additional funds required for expansion may involve renegotiation of the overall buy-out equity structure producing new tensions between management and the venture capitalists.

(ii) Methods of Realisation

Longevity must also be seen in terms of the main exit options available: sale to a third party; sale to the management and/or employees; public quotation on the Stock Exchange; and liquidation

although various forms of financial restructuring may be possible to ensure management remain independent but capital gain is realised (Table 2.4).

TABLE 2.4: FORMS OF EXIT FROM A BUY-OUT		
Forms of Exit	Investors Affected	Extent
Liquidation	Management, financiers	Full
Trade sale (Acquisition by an external group)	Management, financiers	Generally full
Repayment of debt	Financiers	Full/partial
Repurchase or redemption of shares	Financiers	Full/partial
Private placing of shares	Financiers	Full/partial
Internal share market (used in larger employee buy-out)	Difficult for management or financiers to make substantial disposals	Partial
Stock market flotation	Management, financiers	Full/partial
Management Buy-in	Management, financiers	Full/partial
Second buy-out	Management, financiers	Full/partial
Capital restructuring	Management, financiers	Full/partial

Thus the latter may include the repurchase or redemption of shares; capital restructuring or releveraging; repayment of debt; or a second buy-out. Shares traded on an internal share market in an employee buy-out additionally enable independence to be retained while a management buy-in will ensure the company remains private. Liquidation may be on a voluntary basis and reflect a satisfactory exit but, more commonly, will be forced.

A major problem may exist where management do not want to exit or are unable to because of poor performance or lack of willing buyers. Indeed a significant minority do not express an exit intention at all (eg Taylor and Hooper 1989), implying a preferred mode of exit through succession while several studies have shown a high percentage of buy-outs not exiting- eg 70 to 75 percent after six years in Houlden (1990). Indeed such behaviour may imply that the motives

of those responding in surveys such as Taylor and Hooper and Wright, Thompson, Robbie (1992) do not match those of the venture capitalists.

Prospects for realisation may, of course, not conform to original expectations by producing subsequent performance which falls between the successful exit and the receivership exit. Ruhnka, Feldman and Dean (1992) have described the phenomenon of the 'living dead' investments, typically mid to later stage venture capital investments that are economically self sustaining but fail to achieve levels of sales growth or profitability necessary to produce attractive final rates of return or exit opportunities for their venture capital investors, ie a failure of investor expectations rather than outright economic failure of the venture.

Flotation (IPO) normally allows the equity backers to realise some of their investment, managers to reduce their personal indebtedness, encourages the introduction of employee stock option schemes, enhances the status of the company, avoids possible conflict from locked in minority shareholders and raises more equity to fund investment or acquisitions (Bradley-Jones and Hussey 1985, Wright, Robbie and Coyne 1987, Green and Berry 1991). Flotation provides an opportunity to significantly alter the governance of privately held firms (Singh 1990) and also enables managers to retain some form of independence which may be lost on sale to a third party. For large successful LBOs, the firm's investors, particularly managers who own large amounts of the firm's equity, gain access to public capital markets which offer liquidity and diversification of assets (Palepu 1990).

Since 1987 **trade sales** (sale to another corporate entity) have increasingly outstripped flotations as the principle exit route for buy-out investors (Chiplin, Wright, Robbie 1992) coming to prominence because of high merger and acquisition activity generally (Hughes, 1989; Benzie, 1989), as well as offering managers and investors the possibility of total realization of equity holdings frequently at a higher P/E ratio than could be achieved through flotation. It may also

allow managers to sever connections with the firm, pursue a further entrepreneurial activity (for instance a buy-in) or retire. They may not wish to enter into equity partnerships or management contract with other unknown parties. If management wish to remain, they may be able to obtain some cash, an equity stake in the new parent and an attractive service contract. The trade sale may thereby represent a beneficial career move to a bigger company although the idea of this may not have been immediately acceptable to management at the time of buy-out which would in retrospect have been a brief entrepreneurial diversion in a long-term pattern of working for someone else.

Receivership is an extreme form of realisation but important in periods of high interest rates and recessionary conditions (Chiplin, Wright, Robbie 1992). The issues of bankruptcy have to be seen within both business failure generally and buy-outs in particular and may be linked to both internal and external factors. Research into small business failure indicate the relative importance of internal issues such as quality and structure of management, behavioural aspects, inadequacy of accounting information systems, manipulation of published financial statements and gearing as opposed to external factors such as high interest rates, recession, inflation and unemployment (see eg Peterson, Kozmetsky and Ridgway (1983), Argenti (1976), Berryman (1983), Storey, Keasey, Watson and Wynarczyk (1987) with reviews of the evidence provided by Keasey and Watson (1991) and Hall and Young (1990).

In the case of buy-outs, the superior forms of control devices and the extensive due diligence carried out prior to the transaction could be expected to reduce the chances of failure. In particular the majority of internal reasons for failure could expected to have a much lower level of influence. However reviews of UK buy-out experience cited above and others in the US (eg Jensen (1991) and Kaplan and Stein (1990), show a higher rate of bankruptcies at the end of the 1980s than during the early and mid 1980s raising questions as to whether the buy-out form itself is flawed or whether there were particular circumstances such as deal over pricing during the late

1980s which brought this about. This in itself raises questions as to the quality of analysis and judgment used by the buy-out investors who are supposed to be bringing superior quality of control to the target company and whether deals were driven more by the high fees generated by the lead investors and service contracts negotiated rather than rational financial analysis. Indeed Bruner and Eades (1992) demonstrated that tests of capital adequacy would only have predicted, under extremely optimistic expectations, that the Revco buy-out's financial obligations would have been manageable. Issues may also be raised as to whether the initial drive for efficiency after a buy-out reduces the amount of slack so much that when adverse conditions arrive there is little downwards protection available. In some cases expected improvements in operating efficiency and management may not materialise and short term gains may have been at the expense of long term efficiency. Such arguments must clearly not obscure the practical difficulties which are experienced generally in period of economic recession and high interest rates which may have a disproportionately high impact on more highly leveraged companies and the ability of well controlled companies, as described in Jensen (1986), to be re-organised earlier than other companies, consequently being more likely to preserve significant elements of value.

In practice many buy-outs lie between the highly successful and the failures, where the venture capitalist is unable to engineer realisation at a sufficiently attractive multiple of original equity. In such cases, investee companies can be seen normally to be fulfilling their debt contracts but failing in the equity contract as would be expected under Agency Theory. In such cases major issues arise as to how what may be differing aims of management and investors can be met (see eg Ruhnka et al 1992 in terms of venture capital).

2.7 Conclusions

This Chapter has examined key issues which arise in the management buy-in process with particular reference to corporate restructuring, entrepreneurial issues, identification of a target company, deal completion and post transaction issues including performance, turnaround and the

life cycle. A wide range of restructuring opportunities has been seen to exist including divestments from quoted companies and the sale of private companies. The vendor's motivation for sale can vary but frequently reflects lack of profitability of the company, a change in group core activities or succession issues. Management in the buy-out has been able to engineer an opportunity to purchase, and in so doing has become much more entrepreneurially minded. The review of buy-out performance illustrated how the benefits to be expected from corporate restructuring (agency cost reductions, equity incentives, debt bonding) when combined with more entrepreneurial actions result in major operating efficiency benefits, at least in the short to medium term. Key long term issues concerning the buy-out's life cycle show contrasting view points.

Much of the discussion, however, has been in terms of the management buy-out, given the lack of previous specific management buy-in studies although many issues raised in the critical analysis of the literature can also be applied in different ways to buy-ins. Such aspects include the type of entrepreneur, the Team's previous entrepreneurial experience, the search and identification of target companies, the role of the incubator and the way in which a turnaround can be achieved. This raises further issues as to whether different performance and life cycle characteristics can be expected in buy-ins. Chapter 3 develops this further by contrasting management buy-outs and buy-ins in the light of the discussion in this Chapter.

CHAPTER 3

MANAGEMENT BUY-INS IN RELATION TO BUY-OUTS

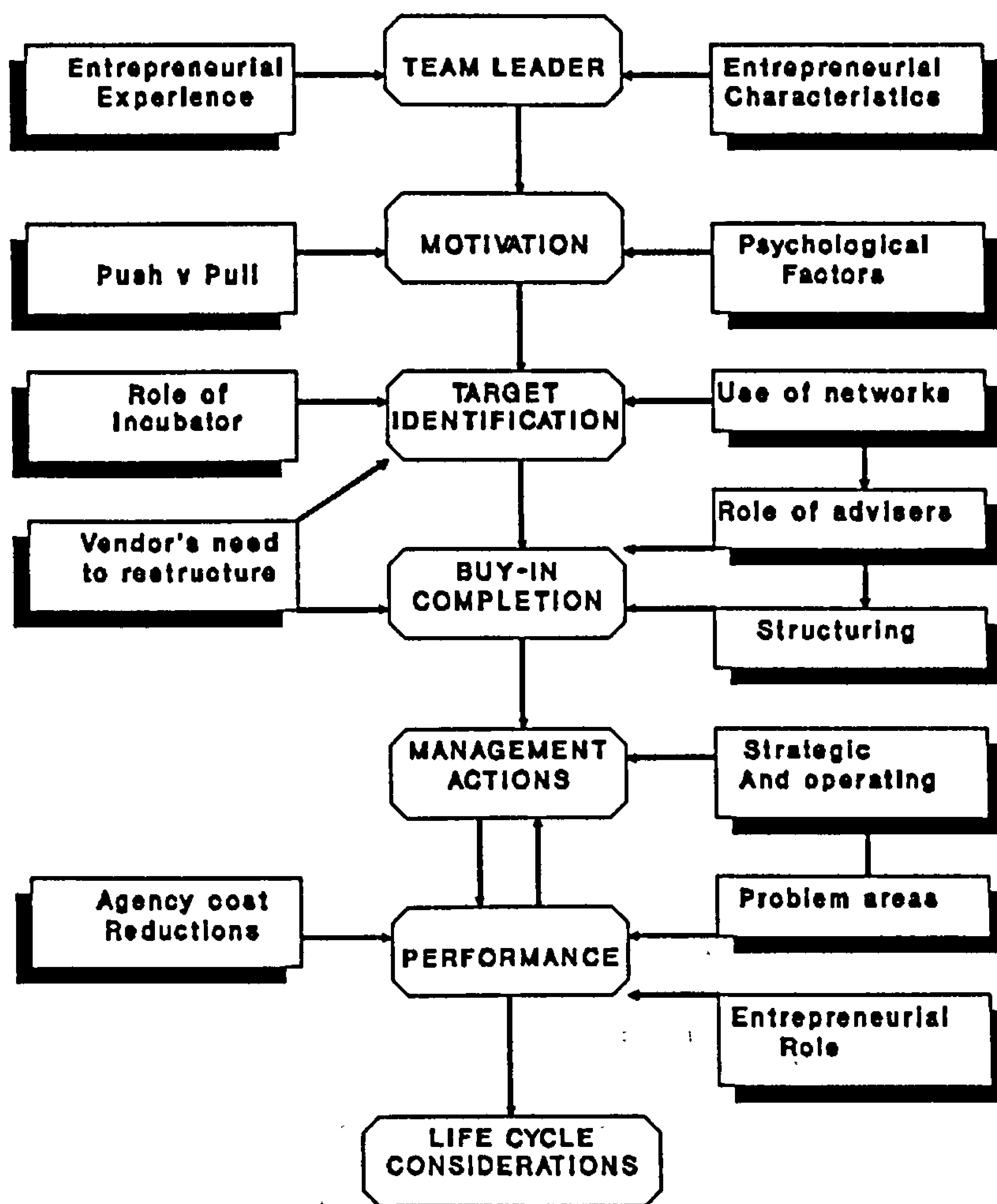
3.1 Introduction

Chapter 2 has raised issues relating to management buy-ins in five main areas: the restructuring opportunity (2.2), the Team Leader and his Team (2.3), infrastructure aspects of deal search and completion (2.4), deal completion (2.5) and post transaction issues (2.6). The recent nature of management buy-ins, as shown in the absence of any previous major buy-in studies, has meant that by necessity examination of literature in Chapter 2 has only rarely been able to refer specifically to management buy-ins. Instead reference has been made to studies in fields where issues are considered to have been relevant as well as to specific studies of management and leveraged buy-outs and venture formation.

However the crux of this thesis is the distinctiveness of the management buy-in as a separate corporate restructuring device and in particular the identification of characteristics which are significantly different from those of management buy-outs. This Chapter extends the discussion and evidence presented in Chapter 2 through further examination of the management buy-in process to show areas of possible difference. These are placed within a framework covering entrepreneurial, personal and motivational backgrounds, target company characteristics, search and identification, deal completion and post transaction issues. Propositions and hypotheses concerning these differences are derived.

Figure 3.1 illustrates important influences in the overall buy-in process. The Team Leader can be expected to display entrepreneurial characteristics (3.2); he may also have had entrepreneurial rather than just managerial experience through the ownership of a venture (such as a buy-out). His motivation will reflect the socio-demographic and psychological factors described in Chapter 2.3, the latter including need for achievement as well as push and pull factors. The vendor's

Figure 3.1: FACTORS INFLUENCING MANAGEMENT BUY-INS



motivation and willingness to sell (3.3) may derive from several reasons and will have an impact on how long the process takes and the final completion price. Target identification will involve consideration of the characteristics of the target company (3.4) as well as search for the company including the use of networks and the role of incubators. Deal completion (3.6) will involve critical elements of financial structuring including equity incentives and debt bonding. Following the buy-in, management may introduce changes which reflect efficiency arguments of corporate restructuring, the strategic and operating considerations of turnaround and the entrepreneur's innovative behaviour (3.7). Actions will influence performance which may be affected by newly developing or unforeseen problem areas as well as other specific factors including Agency Cost

reductions. In the longer term consideration is given to the Life Cycle of the target company. Differences between management buy-outs and buy-ins are shown in Figure 3.2

3.2 Entrepreneurial Influences on Management Buy-outs and Buy-ins

(a) General Considerations

Buy-out transactions have been seen to blend the features of corporate restructuring with an emerging degree of general entrepreneurial skills which are required when management take control of a company, are no longer responsible to normally distant shareholders who had been prepared to accept the risk of management actions on a more remote basis and have to introduce innovative actions to further the business.

At the same time management must be seen in an entrepreneurial setting. Entrepreneurship literature, eg Carland et al (1984), Webster (1977), has differentiated entrepreneurs from small business persons. As a capable executive the entrepreneur must possess the psychological and sociological characteristics combined with the technical and managerial skills to effectively manage the organisation, to provide an adequate return to the stock holders and provide a future direction for the firm (Sexton and Bowman 1985, p 138). Leibenstein (1968) discriminated between routine entrepreneurship (really a type of management) operating in well established and clearly defined markets and N-entrepreneurship where not all markets may exist or operate perfectly, the entrepreneur filling in for market deficiency. Litzinger (1965) sees entrepreneurs as being goal and action orientated compared to managers who carry out policies and procedures in achieving their goals and that entrepreneurship is a phenomenon which comes under the wider aspects of leadership. Schumpeter (1934) saw the entrepreneur as being expert in the use of intuition and strategy. Table 2.3 illustrated entrepreneurial characteristics which had been identified as assuming risk associated with uncertainty, supplying financial capital, acting as innovator, decision maker, industrial leader, manager or superintendent, organiser and co-

ordinator of economic resources, owner of enterprise, employer of factors of production, contractor, arbitrageur and allocator of resources among alternative uses.

Such qualities may first be seen in the Team Leader of the management buy-out who creates a new organisational and ownership form within Schumpeter's wider definition of entrepreneurship (1943) which includes "new forms of industrial organisation that capitalist enterprise creates". The buy-out process in itself involves the formation of a new company to take over some, but not necessarily all, the assets of a company or division and does so most probably in a new combination. In a 'classical' view of entrepreneurship, entrepreneurs notice opportunities, act, and create new hierarchies or ventures to organise transactions and, if successful, reap profits from their transactions (Jones and Butler 1992). Indeed the actual act of carrying out a management buy-out rather than subsequent actions has been seen to be entrepreneurial (Green and Berry 1991).

In transferring to the role of buy-out manager, the former executive will move from a managerial function which he has been performing under divisional or central organisational control to one where as a principal he has a totally different level of strategic control as well as responsibilities for creating initiatives to develop the company. Previously the company's organisation structure may not have allowed for significant internal corporate entrepreneurship. The Team Leader identifies new opportunities, co-ordinates the necessary inputs, organises the raising of capital and accepts a high degree of personal, social and financial risk should the venture prove to be unsuccessful. In some buy-outs, the entrepreneurial edge may need to come from a 'leading light' (Wright and Coyne 1985).

Examination of the perceived nature of management buy-outs and buy-ins suggests that different levels of entrepreneurial functions may be required in the two forms. Through leaving his previous employment, the buy-in Team Leader has assumed a break in the more traditional entrepreneurial

sense. He is to cope with an entirely new combination of factors whereas the buy-out Team Leader is still operating with a lot of familiar factors. The Buy-in Team Leader is not just reacting to corporate restructuring opportunities but helping to create them. Both risk and uncertainty may be seen as being higher given the nature of the move and the asymmetric information available on the company. The management buy-in Team Leader, in contrast to the buy-out, is divorced from the previous structure of the company and the inhibitions and set ways that may have existed before. He brings in a fresh approach with a vision for the future. He shows his entrepreneurial qualities through introducing innovation to the main functions of the target company and re-organising the major factors of production within it to produce new combinations. This behaviour can be seen as producing a special entrepreneurial profit which did not exist under previous ownership. Additionally the innovations required to achieve a turnaround (should that be required) and produce profitable growth are likely to be considerably greater. As in McLelland's scheme the buy-in Team Leader is the person who organises the firm and or increases its productive potential.

(b) The Team

As described in 3.2 major differences can be expected in any ranking of relative entrepreneurial strengths between buy-out and buy-in Team Leaders with the buy-out Team Leader being relatively less entrepreneurial in motivation and outlook, that of the buy-out Team Leader probably having been latent before. In the management buy-out the core Team will have been in existence for some time with normally all the executive directors of the board and senior management remaining. Consequently buy-out teams can be expected to be reasonably large. In contrast the buy-in team is smaller, partially relying on skills which there may be in the target company. The cohesiveness of a buy-in team may be threatened if there are too many members. Consequently there are likely to be skills gap within the team itself.

FIGURE 3.2: POTENTIAL DIFFERENCES BETWEEN MANAGEMENT BUY-OUTS AND BUY-INS		
Factor	Management Buy-outs	Management Buy-ins
1. The Team		
•Entrepreneurial Nature of Managers	Previously latent	Relatively high
•Team's Experience of Working together	Yes	Majority will have at some time
•Managerial skills gap	Unlikely, but could be weak members	Highly possible- eg Finance
•Size	On average 4-6	Small relative to company size
•Managerial Experience	Existing MD/GM plus team	General plus specialist
2. Personal Background		
•Previous ownership of business	Unlikely	Minority- eg mbo experience
•Relocation	Unlikely unless drastic cost saving	Minority
•Minority groups	In line with population distributions	Possible
•Education	Mixed	University/professional, a few self starters
•Age	Average age distributions	Mid career break
•Parental Business Ownership	Possible	Significant minority
3. Team Motivation		
•Desire to realise perceived opportunity	Once in a lifetime opportunity	Various options available
•Financial gain	Moderate	Moderate-High
•Build successful organisation	Moderate	Highly important
•Develop own strategy	Moderate-High	Highly important
•Need for Achievement	Low to medium	High
•Opportunist	Minority	Majority
•Craftsman	Majority	Significant minority
•Displaced	Significant influence	Insignificant influence
4. Vendor Motivation		
•Change in Core Activities	High	High
•Succession Issues	High	High, question of calibre of incumbent mgt
•Lack of Profitability	Moderate	High
5. Target Company		
•Maturity of sector	High	Moderate-high
•Growth prospects	Low-moderate	Good
•New product development	Low-moderate	Moderate-high
•Technology	Low	Low-moderate
•Cash Flow	Strongly positive	Moderate- expansion, acquisition needs
•Turnaround potential	Low-moderate	Moderate-high
6. Search and Identification		
•Use of formal networks	Yes	Informal extensive until target identified
•Long Period of Search	None assumed	Yes
•Failed bid attempts	No	Highly likely
•Problems of Information Assymetery	No	Considerable
7. Deal Completion		
•Entry Price	High PE ratio	Moderate PE ratio
•Initial Leverage	High	Moderate, reflecting risk factors
•High Management Contribution	Moderate	Yes
•Incentive of Equity Ownership	High	High
•Use of Ratchets	Significant minority	Extensive
•Debt Bonding	Yes	High

8. Post Transaction Issues		
(a) Performance		
•Performance Improvements	Significant in short term, questionable in longer term	Significant in medium and long term, but may not be immediate
•Problem Areas	General economic, financial influences, possible over-leverage; insider information reduces risk of over payment	Asymmetric information, higher degree of risk may make exposed to economic and financial uncertainties, over-leverage, overpaying
(b) Actions		
•Working Capital controls	General moderate improvement	Significant changes
•Fixed asset changes	Moderate changes, some unbundling, more cost effective investment	Sell-off surplus assets, but also investment for efficiency
•Acquisition Activity	Moderate, but increases after float	Significant
•Marketing and Product Changes	General changes	Significant
•Recruitment of Specialists	Frequently not necessary	Needed to fill skill gaps
•Resignation of Team Members	Low probability	Reasonable probability depending on extent of having worked together
(c) Governance		
•Monitoring	Monthly reporting	Extensive
•Board Composition	Shareholders board rights implies hands-on approach but hands-off in practice in many cases	"Hands-on" approach, direct board representation
(d) Life Cycle		
•Life cycle period	Mixed depending on product, size, source, venture capitalist, etc	Relatively long to take advantage of result of turnaround, potential growth and innovative actions
•Likelihood of failure	Low, proven company and management	High, depending on suitability of management, asymmetric information, due diligence

The longer term stability of any team will depend on the working relationships which have developed and the recognition and ability to cope with a different range of strengths and weaknesses of individual members. In the buy-out such individual recognition and the ability to work together coherently and purposefully is acknowledged and proven. In the buy-in risks would appear to be reduced if members have worked together currently or recently. Nevertheless this may not be feasible and there may be a significant number of cases where Teams have not worked together before but have had some other type of relationship.

Buy-ins present different problems in that the formation of an appropriate team may be difficult in the first place: following completion gaps may be costly to fill because of the costs involved in injecting these new skills, a position which may be aggravated by voluntary or forced resignations of incumbent management. The risk is further increased should the team not have had experience of working together before; this contrasts with the management buy-out where the team is in situ. Incubators provide the setting which teams can be formed (Cooper and Dunkelburg 1986) with

many founding teams frequently meeting in the incubator (Cooper 1985). This gives rise to the first proposition:

> (P1) Teams will be smaller than in buy-outs with Team Leaders having a typically well rounded General Management background with the Number Two adding specialist skills but the small number in the Team resulting in initial skills gaps. Most Team members will have known each other before.

(c) Personal Background

While features of the personal characteristics of buy-out Teams are likely to reflect general executive demographics, management buy-in Teams may be different, given the influence of entrepreneurial factors discussed in 2.3. In particular Management buy-in opportunities may be seen to be attractive to both successful mid career executives and to entrepreneurs who have sold their first venture or buy-out. Particular issues have been seen to concern the age at which the entrepreneurial decision is taken, previous entrepreneurial experience, location, and educational and parental background.

As Wright and Coyne (1985) indicate, buy-outs would be expected at a later stage (reflecting normal career patterns periods) and be catalysed by a special set of circumstances which results in the owner deciding to sell and thereby enabling the buy-out to take place. In the case of the buy-in, the move by the Team Leader may occur before he has been Chief Executive or General Manager of a company or Division (subject to his ability to succeed in the venture capital screening process) but, given the smaller team, managers may have to provide a proportionately higher personal equity contribution; the necessary accumulation of personal wealth to be able to do this could mean that the Team's finance is not available until a comparatively later age.

Liles (1974) referred to the free-choice age period when employees may be most likely to seek to establish a new venture. Hunt and Colins (1983) saw many becoming entrepreneurs in their

mid 30's, the period from the age of 25 to 40 years old being one of rethinking for many managers in larger companies. Management buy-ins and new ventures are therefore likely to be different from buy-outs. A further proposition can be raised:

> P2 Many buy-in Team Leaders will be attempting the buy-in as part of a mid-career change in what has been a relatively stable employment background;

Chapters 2.3.3 illustrated that entrepreneurs have a high likelihood of starting several ventures during their life and hence are most likely to have previous experience of business ownership. Having engaged in an entrepreneurial act, many will seek another entrepreneurial activity (Ronstadt 1988) even should the earlier venture may have failed. Buy-in managers may have had such experience through having participated in an earlier buy-out which had been realised or (perhaps less likely) through having started an enterprise and harvested it at a later stage. With many new enterprises being essentially small in size during the early stages, there is a greater likelihood that they took place while the entrepreneur was relatively young, ie at an early stage of the managerial career. Thus

> (P3) A significant minority of Team Leaders will be involved in at least their second major entrepreneurial experience of business ownership or will have tried to arrange a management buy-out which did not take place;

Many entrepreneurs start businesses near their incubators and homes (Cooper and Dunkelberg 1986). Doing so enables them to draw upon personal contacts and market knowledge, start part time and results also in less family disruption. Such views are supported by eg Birley (1985) and Hakim (1988). Clearly in management buy-outs changes in locations are unlikely unless necessary to reduce the company's cost base. The supply of appropriate target company for a buy-in may however be limited in the near locality and a move to another region may be necessary. However this will not in itself result in an overall change in regional industrial distributions. Consequently

P4 Unlike buy-outs a minority of buy-ins will involve Team relocation to another region; and

H1 The regional distribution of buy-ins will not be significantly different from those of buy-outs.

Certain minority groups have been seen to have an important influence on the development of entrepreneurship. Low and MacMillan (1988) noted the congruence between ideological constraints and economic behaviour if entrepreneurship is to flourish. Hagen (1960) referred to the disadvantaged minorities seeking to redress social grievances. Existing minority groupings will remain in buy-outs while buy-ins may give more opportunities for minority groupings.

Educational background may also influence entrepreneurship and the type of venture established. Brockhaus (1982) noted that different stages of development requires different mixes of entrepreneurial and administrative abilities and hence different levels of educational background. However the influence of education has produced research with quite varying implications (see 4.5) although it is likely that the education influences on buy-ins and new ventures are likely to be similar. It may be that the venture capital screening process favours entrepreneurs with particular backgrounds. Thus

(P5) Buy-in managers will typically be well qualified in terms of professional qualifications and university education

Parental background has also been seen to be an important contributory factor towards the development of entrepreneurs, providing a role model from early age for budding entrepreneurs to focus on. Buy-in Team Leaders are more likely to reflect this than buy-out Team Leaders.

(P6) A significant minority of buy-in Team Leaders have parents who were small business owners.

(d) Team Motivation

Management's motivation is clearly a highly significant factor in both buy-out and buy-in processes. McLelland (1962) in explaining the Need for Achievement (n-Ach) theory stressed the personal responsibility for finding solutions to problems, moderately challenging achievement goals, taking calculated risks, and wanting concrete feedback concerning performance. The desire to do the kind of work which the entrepreneur has always wanted to is likely to be greater in the management buy-in than buy-out. The buy-in manager is likely to have seen an existing opportunity (perhaps with a specific market or product) which can be more fully exploited while the buy-out manager will take advantage of what may be a once in a lifetime opportunity; this is more likely to be made known to him rather than creating the opportunity himself. In the case of the management buy-in, the Team Leader will have taken the original initiative although this will have to coincide with a decision by the vendor to sell or subsequent persuasion to do so.

In some cases the buy-out manager may be seen to have been essentially defensive in his attitude, responding to an initiative made by the former owner of the company or sometimes initiating the buy-out but only after threat of receivership, redundancy or a new owner had become evident (Wright and Coyne 1985). Storey and Jones (1987) and Hamilton (1989) have noted that employment loss and redundancies and plant closures leads to self employment and new firm formation. Cooper and Dunkelberg (1986) expected more entrepreneurial owners, notably starters and to some extent purchasers of businesses to be from organisations where there had been strong negative pushes. Buy-ins may thus be subject to 'push' factors but these are hypothesised as being of comparatively low importance, the entrepreneur/manager actively looking for a suitable opportunity. While buy-outs may give rise to incumbent managers being able to develop their own strategy (rather than being influenced by existing corporate guidelines) buy-in entrepreneurs may be expected to be more proactive in their desire to develop their own strategy and to build a successful organisation. Financial motivation will be a significant influence but may be seen to be higher in the case of buy-ins. The following propositions are raised:

(P7) Management buy-in Team Leaders can be seen as being more pro-active than MBO Chief Executives and have a relatively high Need for Achievement. In particular MBI motivation can be expected to be little influenced by push factors. Buy-in managers are likely to be seeking to develop their personal long term goals rather than showing dissatisfaction with their previous employment;

(P8) Buy-in implies a considerable personal financial risk which will be reflected in relatively high pecuniary influences in the Team Leader's motivation; and

(P9) Given the basic characteristics of Team Leaders hypothesised earlier, they can be seen as being mainly 'opportunist' in nature although there are likely to be some 'craftsmen'. The presence of buy-in managers principally representing 'push' factors is seen as unlikely. In contrast buy-out managers are seen as less opportunist and more likely to be influenced by 'push' factors.

3.3 Vendor Motivation

Corporate restructuring may arise as a result of an internal decision by a parent to divest reflecting varying degrees of necessity such as an unwanted part of a recent acquisition, change in corporate strategy, lack of profitability, need of parent to raise cash- or a hostile set of circumstances such as an unwanted external bid for the company (see Chapters 2.3, 2.4). For companies in private ownership further reasons for restructuring could be that no family successor is available. Political changes have brought major restructuring to the public sector involving the sale of activities and the opening up of competition to others. Additionally under performing quoted companies were subject to action by predators who saw the potential for improvement by reforming the company, reducing overheads and using more leveraged financing structures (Chapter 2.5).

In the subsequent re-organisation, the vendor may not wish to sell to incumbent management who may be considered too weak in terms of managerial skills and hence ability to attract. Management may not meet price expectations raising suspicions that they are using available information to artificially depress the price but possess inside information of more positive factors. Buy-ins may be a more favourable outcome providing stronger management, more attractive pricing and bypassing dangers of manipulation of inside information.

Additional considerations may apply in the sale of privately owned companies. A highly entrepreneurial vendor may be keen to retain the company in private ownership but may not have created a strong entrepreneurial succession. Vendor hopes for the longer term independence may rely upon the introduction of new management of the correct calibre from outside who can replicate the leadership and entrepreneurial characteristics of the founder or retiring private owner. He may also want a continuing relationship. Consequently

(H2) Sources of private buy-ins are significantly different from buy-outs; and

(P10) The vendor's motivation to sell the business will be strongly related to change in core activities and in the case of private vendors succession issues with poor profitability being important in both privately owned sales and divestments.

3.4 The Target Company

Buy-outs especially in the United States have been seen as coming from mature sectors of the economy against a stable low growth background in industries which have substantial and predictable cash generative characteristics frequently associated with low levels of R & D requirements (eg Easterwood at al 1989, Lehn et al 1990) and where previous financial performance may not have been inspiring. As the reasons for such characteristics can be ascertained, a limited degree of post buy-out reorganisation would be necessary to achieve more organisational efficiency by way of cost saving and improved cash flow and the probability of

unexpected problems emerging to threaten the future existing profitability of the new company seen as low. Consequently buy-outs may not be appropriate for industries with rapidly changing technology, fast growing industries where there is the threat of new entrants, high supplier or buyer powers, risk of technological obsolescence or overcapacity resulting from industry level factors not under managerial control.

Management buy-in motivation (3.2) has been seen to be more orientated towards building a successful business, achieving growth and applying skills in a more innovative manner. Buy-ins may therefore be in a less mature industrial sector than the buy-out, have better growth prospects but may probably involve more new product development. There may be significant cash requirements to allow for both organic growth and acquisitions. Consequently

(H3) Industrial activities of private buy-ins are significantly different from buy-outs; and

(P11) Company characteristics will differ from those of buy-outs by having potentially significant cash requirements, being in a less mature but more growth orientated sector and involving products where there is higher technology risk.

A further aspect concerns the turnaround potential of the two types of transaction with diverging degrees of action being taken in post transaction management. While buy-outs may take place in a significant number of loss making and under-performing companies (Chiplin, Wright, Robbie, 1992) the problems giving rise to this unsatisfactory position can be carefully assessed by management and their backers and the turnround potential effectively underwritten. In the case of management buy-ins, the need to add value to the company and benefit from the superior management skills seen in the new management team imply a high turnaround probability factor. In many cases the causes of the target's previous under-performance may be the result of previous weak management (Batchelor 1987). Thus

P12 A major motivation for purchase of a particular target is the possibility for achieving a turnaround.

3.5 Search and Identification

Entrepreneurship theory suggests that existing industrial knowledge, proximity to home and the use of informal networks are important considerations in the search for a venture. Entrepreneurs may be particularly influenced by their previous employer- eg in terms of wanting to start up in a similar (and competitive) capacity or formulating an idea as a result of this work. Buy-out and buy-in teams may be expected to have different search and identification processes. In a buy-out there is essentially only one buy-out opportunity which will be identified depending on the vendor's motivation for selling. As soon as this is known the Team may then progress directly to formal advice networks. Buy-ins are different in that a target company has to be identified and its availability for sale ascertained. Completion success is not guaranteed given that hit is followed by detailed negotiations and due diligence; this may raise further problems including pricing resulting in non completion and the start of the process again, the potential costs of search being high.

While sophisticated search methods are available nowadays, Team Leaders may not be able to take advantage of these. It is possible that informal and casual methods will be used in the initial identification methods, implying a relatively long period of search. The chances of selecting a company using personal identification methods will be higher when the company is in the same sector and a member of the team has some knowledge of it (eg competitor, customer). At this point more formal advice will be taken, professional advisers appointed and a venture capitalist sought. The failure to access information concerning availability of target companies may result in major search inefficiencies. A large problem may exits in matching Teams with appropriate target companies.

The following propositions may be raised:

(P13) The period required to complete a buy-in will be significantly longer than in buy-outs and may well involve failed attempts for other targets;

(P14) The target company is likely to be in the same sector as the Team Leader's existing company; consequently personal knowledge and the use of informal rather than formal networks will prove more important elements in target identification than more sophisticated methods of company search; and

(P15) Unlike many US LBOs the Team will be expected by institutions to identify the target.

3.6 Deal Completion

In both buy-outs and buy-ins management can be expected to have a high incentive of equity ownership enhancing entrepreneurial actions, failure to perform resulting in the possibility of substantial personal financial loss. The fortunes of the individual are aligned with those of the company. However differences in financial structuring can be postulated.

The overall stability of the buy-out company (market position, established profitability and cash flow record, full disclosure of information, low probability of "skeleton in the cupboard" problems) implies a lower degree of risk and higher level of initial leverage. Despite this higher proportion of institutional equity in the management buy-in financing structure (in terms of both the institutional equity share and the overall debt: equity ratio), the effect of debt on managerial incentive will be planned by the financial backers to be at least as high to management in the buy-in. There will remain a high commitment to servicing significant levels of external debt and quasi-equity finance.

This apparently higher degree of risk will also be reflected in the price which the buy-in team is prepared to pay com[pared to a buy-out. With higher uncertainties, despite the buy-in Team's view that they can significantly improve performance, the venture capital backers will want to decrease the risk factors by paying as low a price as possible and not being prepared to bid on the same scale as incumbent management. The following hypothesis can therefore be raised:

(H4) Management buy-ins will have lower leverage, lower entry PE ratios and prices than management buy-outs.

Given the different nature of the financial projections which can be made during the deal appraisal period and the probability of management being more optimistic than their financial backer, venture capitalists will seek equity incentive devices which give management set targets and limit their own downwards risk. The following proposition is suggested:

(P16) The need to provide incentives to management will lead to extensive use of ratchets to enhance the Team's equity position.

3.7 Post Transaction Issues

(a) Performance Improvements

The development of extensive corporate restructuring was justified on the grounds of subsequent performance improvements from Agency Cost reduction. Replacement of distant shareholders by a combination of management and buy-out organisations or venture capital firms aligned managerial and shareholder interests. New non-management principals had direct access to monitoring and control functions and were able to input to the company in a way which had not been possible before. Shorter distance between ownership and control reduced agency costs and hence improved performance (eg Fama and Jensen 1982) although Sahlman (1990) has pointed out the significant agency costs involved in the providers of funds to venture capital partnerships in monitoring the investments made by the venture capitalists on their behalf. Agency cost

reductions were particularly high for companies which de-listed from the stock market and were thus not subject to costly information and regulatory provisions.

In both buy-outs and buy-ins the incentive of personal equity ownership can be expected to make management introduce measures to improve corporate efficiency while the need to repay debt puts pressure on management to run the company efficiently with particular emphasis on significant cash generation. Investment plans with negative net free cash flow would be abandoned and excessive administrative, managerial and operating costs eradicated. The resultant improvement in efficiency would wipe out organisational slack.

In the short term buy-out managers are able to quickly improve efficiency but may not be able to provide a continuing rate of improvement beyond in the medium term when initial ideas have been thoroughly tried. In the longer term dangers exist in that as the company grows larger and the initial entrepreneurial impetus is left behind, management benefits from the initial improvement in performance. A different behavioural pattern may then set in where innovation is not so pronounced and inefficiencies allowed to develop. Additionally few individuals are able to sustain the entrepreneurial attitude across their careers (Schumpeter 1934).

Such considerations apply generally to both buy-outs and buy-ins but in the latter there may be higher monitoring costs involved given the higher uncertainties and risks hypothesised. In the case of buy-ins of privately owned companies there is also the danger that the agency costs would be higher than in previous total ownership by an entrepreneurial founder. However while the Agency Cost argument can be seen to be important, the high costs of information asymmetry encountered by both management and the venture capital sponsors may not lead to the speed of initial improvements which could be expected in management buy-outs, indicating that the phasing of performance improvements may be different.

At the same time buy-in performance must be seen to be related to a combination of factors described in Chapter 2, some of which may apply generally to buy-ins while others will be distinct from buy-outs. Key factors include the knowledge which entrepreneurs have of the sector which they target, their own personal relationship including work experience and knowledge of the actual target company. Furthermore, as discussed above, different sectoral distributions which have been hypothesised may lead to different growth patterns.

It should also be noted that while the main reason for selecting a target may often be its under-performance (Shaw 1987), the purchaser may not only misread the upside potential but also underestimate the company's problems. Managers involved in a buy-in are frequently looking for a target with considerable turnround and or growth potential increasing the expected extent of post buy-in changes. In comparison the buy-out manager, having excellent internal knowledge of the company, will have formulated in advance of the transaction the types of changes which will be required when the company is independent of its former parent. Although information asymmetry is most acute where the long term funding of high risk new ventures is concerned (Dixon 1991), the management buy-in team and their financial backers in contrast are having to cope with problems of asymmetric information about the firm which may be compounded by the parlous state of the target company (Hutchings 1987). They do not possess the detailed information held by incumbent management and will be further disadvantaged when due diligence procedures have been difficult to perform. However within the buy-in sample the following hypotheses can be raised:

(P17) Buy-in performance is likely to be related to a combination of factors encompassing entrepreneurship, corporate restructuring, turnaround and company specific influences. Better performers are likely to be associated with :

(a) Entrepreneurs who have a high level of education; have been business owners themselves; entrepreneurs who have specifically had earlier experience of being in a management buy-out or buy-in Team; those with a high need for achievement; Teams who

have a high degree of working experience together; and teams which move within the same industry;

(b) Financial structuring which includes a relatively high level of debt bonding, ratcheted equity incentives, a high level of management ownership and are backed by venture capital firms with a hands-on approach; and

(c) Target companies which are medium sized, have been subsidiaries of significant parents and are at least profitable.

The period of the survey coincided with the first sharp fall of economic activity and financial uncertainties of the 1990-1993 UK recession. The level of business confidence fell markedly from August 1989. Such developments are likely to have brought particular problems to companies which have been financed on the basis of relatively high leverage as well as to Teams in term of personal lending taken out to complete the equity of the buy-in. As a result differences may be found in terms of performance of the buy-ins in this period but also in the level of financial actions and capital control required to mitigate the effects of such high financing costs. Such actions may of course not have been enough to rectify deterioration and combined with the assumptions that the risk factors in buy-ins are higher than in management buy-outs, have led to a significantly higher degree of failure. Such considerations give rise to further propositions:

(P18) Like many new ventures the most serious problems are likely to be of a financial nature particularly the availability and cost of credit and finance; and

(P19) A particularly serious problem is likely to derive from information asymmetry when completing the transaction which results in major problems emerging after completion which were not revealed in due diligence procedures.

(b) Actions

Management buy-ins are also more likely to be planning to achieve a major turnaround which previous management may not have been able to achieve. The methods for accomplishing this performance improvement are also going to rely on the adoption by the incoming manager of an entrepreneurial role- taking innovative actions to create the turnaround. Such developments may be triggered by a series of actions (Grinyer, Mayes and McKiernan 1990) and may include change in top management and ownership. Reasons for need for turnaround have been seen in Chapter 2.2.6 to have been caused by management, financial factors, high cost structures, under-utilisation of fixed assets, unwise acquisition strategies, poor marketing, competition, production and labour problems.

Bibeault (1982) and Hofer (1980) have stressed that external management are necessary for successful corporate turnaround. Hofer (1980) notes that incumbent management have a strong set of beliefs about how to run the company many of which must be wrong for the current problems to have occurred. Hoffman (1989) notes that change of Chief Executive stimulates change, unfreezes existing assets, provides new views of the situation and creates the levels of stress or tension required to stimulate organisational change. It will result in new strategic orientation and stimulate innovative, entrepreneurial behaviour through new management. The types of different action which are then possible were detailed in Chapter 2.6.3 above.

Need for turnaround will mean a higher degree of trading risk. However, following the buy-in there is also a high chance of unexpected problems developing and even when this does not happen it will normally have been assumed that there will be considerable restructuring required. Consequently different degrees of action can be expected after the buy-in than is typically seen in a management buy-out. The following propositions and Hypothesis can be raised:

(P20) Management buy-ins are followed by a period of a high rate of change in a company which is especially pronounced in the areas of finance and product and marketing;

(P21) The level of financial actions taken after buy-ins will be high in relation to improving working and total capital ratios reflecting the need to service debt. Fixed asset change (acquisition, sell-offs, unbundling) will be carried out to a lesser extent than working capital action;

(P22) Major marketing changes will be implemented including a high degree of rationalisation of product ranges and the introduction of new advertising and promotion arrangements;

(P23) Managerial re-organisation will be a particular feature involving a high degree of change relative to buy-out and including the recruitment of both senior specialists and former colleagues as Directors; and

(H5) Comparison of actions with other types of transaction- management buy-outs, new ventures and turnround/sharpbenders- will reflect some significant differences in the extent of financial and marketing changes.

(c) Governance

Emphasis has been placed in 2.6.5 on the different governance systems which apply in the case of venture capital investments. The role of investors is also likely to vary between the stages of finance. Many buy-outs with their backgrounds of mature businesses in stable sectors and with known performance influences should require the minimum of investor involvement: in contrast the problems in buy-ins and the need to guide the company through possible high growth strategies will require a more hands-on approach by investors. In the case of investments by some LBO Associations this approach will extend not just to regular monitoring but also through the use of directors and in some cases to installing their own Association management. Investor control issues are likely to be highly focused for buy-ins with higher levels of monitoring required.

This leads to the proposition:

(P24) Venture capitalists can be expected to monitor and control management buy-ins in a "hands-on" rather than "hands-off" manner, with greater intervention used than in management buy-outs.

(d) The Life Cycle

The buy-in has also to be seen in the longer term. Differences have been seen in attitudes to the longevity of the buy-out, some seeing it as a permanent form (eg Jensen 1989), others as a purely transitory form (Rappaport 1990) while others have referred to the short term 'honeymoon' period (Wright and Coyne 1985). Chapter 2.6 has shown the different factors which bear upon the company in traditional life cycle theory and the relevance of contingency theories. In particular the role of venture capital institutions and the factors which bear upon their investment time scale can be expected to be a major determining factor as well as the performance of the buy-out (Wright et al 1993).

However after the buy-out the initiator (ie Team Leader) may assume over time a more managerial role reducing although not totally relinquishing the role of entrepreneur. Nevertheless Team members will still be risking their personal wealth and in some cases a high degree of subsequent innovation will continue. Many buy-out companies had been relatively efficiently run under the previous ownership structure although some innovative action previously not considered possible may now be introduced. In larger transactions the small initial nucleus of entrepreneurs who have established the buy-out may in the longer term effectively delegate the entrepreneurial process to other members of management, returning themselves to a more managerial and monitoring function.

However buy-ins may be liable to different patterns of life cycle from management buy-outs. The initial aspect of turnaround may result in performance improvements being subject to considerably

more variation than in the case of management buy-outs. The act of turnaround will in itself take time. For instance Zimmerman (1991) has noted that in the early years of turnaround there may be an even more pronounced decline in the company's relative performance before the action taken starts to help. Venture capitalists may be expected to monitor the buy-in more carefully, given the risk factors actively guiding the company's growth strategy. This in itself will have further implications for the buy-in life cycle, allowing action to be taken at earlier stages.

In the case of buy-outs the entrepreneurial act of buy-out may be followed by a return to more managerially rather than entrepreneurial directed efforts. There is traditionally an inability to maintain innovation and high degrees of entrepreneurship as a company becomes older and larger (eg Kanter 1983, Mintzberg and Waters 1982) and is subject to more complex hierarchies. In buy-ins, certainly for a prolonged initial period, the Team will be behaving in an entrepreneurial fashion as they can be seen to be introducing new innovations, co-ordinating factors of production in new combinations and identifying and acting on new opportunities. The consequent pattern of growth may therefore allow the buy-in form to last longer. There would appear to be a case that buy-ins involve a longer term form of company than buy-outs but one in which the potential returns may be higher. Some will want to remain independent for a considerable period. Although Schumpeter (19**) noted that people could not be expected to be entrepreneurial for their whole lives, the buy-in leader has been shown as having a higher degree of entrepreneurship than the buy-out leader.

Exit may be dependent on turnaround and creation of a larger group which could be achieved through further entrepreneurial combinations such as a merger or reverse-in as a means to retaining independence. The higher risks and uncertainties may also lead to earlier failure in companies which are not seen as viable. This may even result in the comparatively early termination of the buy-in's life cycle through being placed in bankruptcy should the venture capitalists not see a long term future for the company. The last hypothesis raised is:

(H6) Buy-ins represent a higher risk structure than buy-outs and are aimed for longer life: consequently they will have different exit patterns and be especially prone to receivership.

3.8 Conclusions

This Chapter has discussed the management buy-in in terms of the overall issues of the buy-in process and compared important areas of these with management buy-outs. This analysis has shown the impact of corporate restructuring, agency cost and entrepreneurship theories, turnaround and longer term re-organisation and strategy and the role of venture capital on the understanding of management buy-ins. It has been possible to hypothesise that management buy-ins are a distinct organisational form despite its obvious similarities to the management buy-out. They can be seen as an extension to the options in corporate restructuring and one which establishes new ground between the traditional view of the entrepreneur and the more managerially orientated buy-out while reinforcing the potential gains to be made through the process of corporate restructuring. The management buy-in involves management with relevant experience, applying skills in a different environment, initiating and seizing an opportunity, accepting a high degree of personal, social and financial risk and in many cases doing it against a risk of a much higher degree of asymmetric information than in buy-outs. Additionally such skills and characteristics may frequently be considered to be applicable to situations where a financial turnaround is necessary and in the opinion of the venture capitalists cannot be engineered by the incumbent management.

The following Chapter describes the methodology which will be used to test the Hypothesis and confirm the propositions.

CHAPTER 4

RESEARCH METHODOLOGY

4.1 Introduction

In order to test the hypotheses set out in Chapter 3, an empirical approach was used which was divided into four parts. First buy-ins were identified and their basic characteristics entered onto a database to allow analysis of their general characteristics (4.2). Secondly a mailed questionnaire survey of management buy-in companies was undertaken in 1990 (4.3). Thirdly the hypotheses requiring more detailed information were dealt with by means of detailed case studies of a sub-sample of buy-in companies selected from the sample used for the mailed questionnaire survey (4.4). This Chapter examines the research methodology employed in these three main areas.

4.2 Basic Data on Management Buy-ins

Until 1987 there had been little institutional, adviser and academic interest in the separation of information on management buy-ins from the general statistics on management buy-outs maintained at the Centre for Management Buy-out Research following its founding in March 1986. This source of information on management buy-outs, which by April 1993 covered 7,000 UK and European transactions, was collected by the author from 1986 as an addition to the initial information on 111 buy-out companies gathered by Wright and Coyne (Wright and Coyne, 1985).

Initial research in this area made no distinction between various types of transaction within the generic buy-out category. By 1987, however, it was becoming clear that the management buy-in was emerging as a distinct category. Consequently methods for retrospective identification of buy-in transactions from earlier in the 1980's were established allowing a database to be constructed with basic characteristics of buy-ins: this was then extended to identify new transactions on a regular basis. The sources of information used to obtain this information were principally financing institutions (the author surveys 150 of these on a confidential basis every six months);

press cuttings (supplemented by quarterly Textline searches); Extel and MacCarthy cards; specialist periodicals such as *Acquisitions Monthly* and *Mergers and Acquisitions International*; examination of Annual Reports and Accounts of major companies; Extel summaries of announcements made to the Stock Exchange; liaison with professional advisers; and managers who made direct contact with the Centre for Management Buy-out Research. The various sources of information allow a considerable amount of cross reference of information to be done with the associated verification procedures increasing the overall accuracy of the database. This database represents the only comprehensive source of listings of management buy-ins and has the unique advantage of containing information normally classified as confidential by financiers. Results of the data analysis were originally published in Robbie (1988) with updates provided in Chiplin, Wright, Robbie (1988, 1989a, 1990, 1991 and 1992).

Initially starting with collecting information concerning the type of buy-in, value, activity, location and name of Chief Executive this set of variables was expanded in late 1988 to cover the source and, where possible, financing structure, institutional backers and professional advisers. Data is returned from financiers and advisers on Institutional Investment Return Forms (Appendix A1) or alternatively completed by the author.

Supplementary information on progress and ultimate realisation is also obtained from the same sources and placed on Institutional Realisation Return Forms (Appendix A2). Additionally for realisation through administrative receivership, lists of buy-out and buy-in companies are checked against lists of names of companies compiled by Touche Ross from The London Gazette.

Data is initially coded, verified and entered onto the Centre for Management Buy-out Research's SIR Database systems using the Forms system (SIR, 1987) and is held on the University of Nottingham's VME ICL computer system. Information is retrieved either through SIR/SQL+, an interactive relational query processor, or through SIR/DBMS for more advanced applications.

4.3 Management Buy-in Survey Questionnaire

Having posed the research questions and the hypotheses outlined in Chapter 3, it was necessary to determine the methods by which these could be answered or tested. These processes were seen to include determination of the source of data; designing the data collection forms; designing the sample; collecting the data; processing the data; analysing it; and presenting the results (Kinnear and Taylor, 1983).

To ensure as large and representative a sample as possible, it was decided to contact all public and private management buy-ins completed in the period 1985 to 1989 inclusive for which a contact name and full postal address could be established. It was felt that inclusion of the relatively small number of buy-ins completed earlier than this would be likely to distort the overall sample. Through the use of the database described in Chapter 4.2 above and the author's personal contacts with institutions, a significant number of buy-ins whose names were not publicly known could therefore be accessed providing a uniquely comprehensive sampling frame for the survey.

Consideration had to be given as to how the data could be collected, there being three main methods: personal, telephone and mail interviews (Kinnear and Taylor, 1983). The financial and human resource cost of personal interviews for a sample of this size ruled out this method while cost considerations and the dangers of 'top of the head' and inaccurate responses made telephone interviews inappropriate. It was therefore felt that the survey should be based on a postal survey questionnaire form, but supplemented by personal interviews in a limited number of cases to supplement background information and test hypotheses which may not have been satisfactorily answered through the main data collection process (see 4.4). This method could be expected to provide satisfactory geographical spread at a low level of financial cost, be completed speedily (although giving respondents adequate time to reply), eliminate interview bias and help to conserve confidentiality and anonymity which were thought to be particularly important aspects. Nevertheless it was recognised that the cost of such a survey is frontloaded in terms of the

necessary planning, piloting, printing, sampling, mailing and follow-up (Oppenheim, 1966). The major risks were seen to be the chances of a low response rate which would affect the reliability of the survey results through producing a non-response bias (although later testing did confirm the reliability of the sample), the possibility of lack of control over forms not being filled up by the Team Leader and respondents reading questions in advance of those they were answering; and questions being misunderstood.

Considerable attention was therefore paid to the questionnaire design so that each question was relevant and objective (Crouch, 1985) and the overall questionnaire appeared well structured, logical, straightforward and easy to complete. Care was also taken on the wording of questions to ensure that they were unambiguous, not misleading, did not have loaded words and did not have double negatives.

The questionnaire was designed to obtain information principally on a fixed response basis. A significant number of questions were on a multiple choice basis considered by Crouch (1985) to be the most difficult to design as one need to know what to ask as well as all the possible answers. Possible responses need to be collectively exhaustive but mutually exclusive. To cover cases where it was felt impossible to include all options to answers, space was left for the respondent to specify an 'other' factor which he felt was important. These responses were later categorised and coded to provide additional fullness of response. For ease of response respondents were asked to circle 'yes' or 'no' answers to many of the fixed response questions. Both the multi choice and dichotomous questions had the advantage of easy coding for later data analysis.

Completely open ended questions were kept to a minimum principally reflecting sensitive areas such as attitudes towards advisers where it was felt that respondents could be unduly influenced by a predetermined set of response alternatives. In such cases responses were analyzed manually before determining if suitable categorisations could be made for coding purposes. Space was

additionally left at the end of the questionnaire (Question 48) for the respondent to add any further observations about the buy-in process.

A limited amount of 'hard data' was sought, for instance in the form of financial structuring information, turnover and operating profit at the time of buy-in, employment levels and the sums involved in subsequent acquisitions and divestment. Reliability of this data may however depend on the functional background of the person completing the form, eg a person with financial or accounting experience being most likely to provide accurate financial information. While it was felt that this information would prove useful, care was taken to cross check accuracy where feasible against information held at the Centre from other sources and from Companies House microfiches of Annual Report & Accounts and other statutory information.

The content of the Questionnaire (see Appendix A3) was designed to provide information about the company, the buy-in process, the managers and subsequent progress and actions in logical order with managers not being discouraged by unfriendly questions near the start. After initially requesting details about the Company, the first section of the questionnaire (Questions 1-10) requested information about the transaction itself including aspects of the negotiations, finance, professional advice and financing structure and limitations. Section 2 (Questions 11-19) asked about the new owners with specific questions on the social, educational, career, managerial and financial backgrounds of the Team Leader and 'Number Two' as well as motivational and initiation factors. Section 3 (Questions 20-27) sought information about the target company including search criteria, identification, methods of search, previous knowledge of the company and failed attempts at buying other targets. Section 4 (Questions 28-36) examined actions which had been taken by the new management team after the buy-in including operating, strategic and managerial changes, acquisitions and divestments, incentive systems and employment. Section 5 (Questions 37-42) asked about performance post buy-in with an emphasis on problems which may have developed, requirements for further finance and exit intentions and realisation. Section 6

(Questions 43-47) covered aspects of public buy-ins but because of the low sample (see below) has not been used. Question 48 asked for any further comments the managers might have and was followed by a request for the manager to be allowed to be contacted in the future to discuss the progress of the buy-in.

To ensure that a questionnaire had been designed which could elicit an acceptable response, two major external screening processes were undertaken: the seeking of comments from advisers and a limited testing of a prototype questionnaire. Following comments by institutions, professional advisers and directors and some associates of the Centre for Management Buy-out Research on an initial version, certain modifications were made to the questionnaire. A pilot questionnaire was then sent on the author's behalf by Barclays Development Capital Limited and 3i plc to certain of their clients in November 1989. Following return of the questionnaires, telephone interviews with the respondents were held concerning comprehensiveness of the questions, ease of response and the possibilities of inaccurate information being supplied on certain questions before the final design was made.

At this point considerable attention was paid to physical aspects of the questionnaire to design it to ensure positive feeling was generated and maintained (Oppenheim, 1966). To help response rates by making the questionnaire look attractive, the layout was improved and quality of paper and print ascertained. The front cover was designed with the Centre for Management Buy-out's logo, the name of the survey obvious and the confidentiality emphasised by a large Confidential Block.

Contact was made with individual equity institutions which accounted for almost 90 percent of the institutionally backed private buy-ins as to the method of approach which would be most likely to result in the questionnaire being completed. In general this was done through the provision of introductory letters signed by an Executive Director of the relevant institution to be sent out

through the Centre or for letters on the Centre's headed notepaper referring to the support for the survey given by the institution (Appendix A4). The letters were word processed to a standard format and signed individually by the author. In ten cases questionnaires were sent out directly by institutions for confidentiality reasons. (Confidentiality undertakings were given to both management and institutions for all targeted buy-ins). For private management buy-ins not covered in this way, a letter was sent directly to a named director.

The letters were carefully constructed to gain the interest of the potential respondent by establishing the purpose of the study, identifying by whom it was being undertaken and the sponsorship of the project, an explanation of what was required of the respondents, explanation of the benefits of the survey both to them and future buy-in teams and emphasising the independence and confidentiality of the survey. Respondents were also promised a copy of the published results of the survey[1]. To further emphasise the credibility of the survey, details about the activities of the Centre for Management Buy-out Research were also enclosed. The letter and questionnaire were sent out at the end of February 1990 to private management buy-ins. A stamped addressed envelope was enclosed for their ease of reply, both the outgoing and return envelopes being stamped with first class stamps.

Questionnaires were sent out one week later to both partial and complete public management buy-ins for the same period. Mailing was arranged directly by the Centre to the company using addresses obtained through the Stock Exchange Year Book. For both groups of buy-ins, one month following the initial mailing of the questionnaire a follow-up letter was sent enclosing an identical questionnaire (Appendix A5).

[1] Each respondent was sent a letter thanking them for their participation on receipt of the completed questionnaire. This was followed by a copy of the summarised results as published in Robbie, Wright, Chiplin (1991) on its publication in May 1991 with a covering letter.

Of the 208 questionnaires sent to private buy-ins, 62 were returned completed, a response rate of 29.8 percent, and a further 11 (5.3 percent) with reasons for not completing stated such as lack of time, confidentiality or in one case bereavement of the Team Leader. Of the 118 sent to public buy-ins, 7 were returned completed (5.9 percent), 10 (8.5 percent) were not completed for reasons such as lack of time or confidentiality and a further 8 (6.8 percent) were returned by the Post Office as having moved. The low rate of response for this element of the sample was felt to be due to the restrictions on time availability of Team Leaders in quoted companies and the considerable degree of restructuring which has followed many of these deals sometimes involving the instigating managers leaving the company within a period of two or three years.

Comparison was made with response rates obtained in previous Centre for Management Buy-out Research buy-out surveys. The original Wright/Coyne survey had a response rate of 58.1 percent-111 out of 191 questionnaires sent out (Wright and Coyne, 1985). Given problems both of identification and confidentiality at the time, the questionnaire in this earlier survey had been mailed only to Buy-out Team Leaders who had initially been approached by their venture capital backer and had personally indicated their willingness to participate in the survey to the institution. More relevant comparison can be made between the buy-in survey and that of 1983/85 buy-outs (Wright, Thompson, Robbie 1992) in which survey sample targeting and administration was executed similarly to the buy-in survey. The 1983-85 buy-out survey achieved a response rate of 29.8 percent, identical to that for private buy-ins with 182 usable questionnaires returned out of 610 sent.

Two main problems were noted in the response rate. First the response rate for public buy-ins was unacceptably low and meaningful statistical interpretation would not be possible as a result. Consequently it was decided not to proceed with an analysis of public buy-ins. Secondly there were three private buy-in returns which were irregular. Two involved companies which were effectively located outside mainland Britain (one in the Channel Islands and the other in Norway)

and the third was the only response from a 1985 buy-in. These were therefore also discarded from the main sample leaving 59 private buy-ins to be anlalysed.

To check that the 1986-1989 private buy-in respondent companies were a representative sample of buy-ins of this period, statistical testing of some basic characteristics was carried out to identify any significant differences between these 59 companies and the overall population of 1986-89 private buy-ins as held by the author on the main database at the Centre for Management Buy-out Research. A Chi-square goodness of fit test was used against distributions predicted from the main database for variables such as year of buy-in, region, industrial classification and value range.

TABLE 4.1: GOODNESS OF FIT TEST OF SURVEY SAMPLE BUY-INS WITH OVERALL CMBOR POPULATION OF BUY-INS		
Variable	Degrees of Freedom	Chi-Square
Year	3	0.46
Region	4	2.06
Industrial Activity	4	0.51
Value Range	3	0.16
Note: at the 5% level results for both private and private and public-buy-ins showed no significant difference with the overall population of buy-ins		

Results are shown in Table 4.1. At the 5 percent critical level, the actual survey sample distributions for private buy-ins were not significantly different from the overall population of private buy-ins held on the CMBOR database; consequently the survey sample was considered applicable.

While the actual sample of private buy-ins thus appeared to be satisfactory, there is in any survey questionnaire the possiblility that there may be a lack of robustness due to speed and quality of response. For instance later respondents who had been sent follow-up letters may demonstrate different characteristics from those who replied promptly at the time of the original request (see

eg Boyd and Westfall 1972). To test that this was not the case a series of average sample runs tests (using F-tests) were carried out on major variables used later, eg in the cluster and factor analysis (Table 4.2)

TABLE 4.2: RESPONSE TIME DIFFERENTIALS					
Variable	F-Value	Significance	Variable	F-Value	Significance
Whybuy1	0.0318	0.8592	Source	0.4779	0.4924
Whybuy2	2.1745	0.1463	Mexhow	0.7051	0.4049
Whybuy3	4.7528	0.0338	Mceoed	0.7454	0.3919
Whybuy4	0.0269	0.8704	Mceoage	0.0599	0.8076
Whybuy5	0.4911	0.4866	Mknow	0.7548	0.3889
Whybuy6	0.0122	0.9201	Mceosig	0.0461	0.8309
Whybuy7	0.0084	0.9274	Mindknow	0.000	1.0000
Whybuy8	0.000	1.0000	Moptrend	0.0835	0.7739
Whybuy9	0.0695	0.7931	Mtotrend	0.9115	0.3443
Whybuy10	0.7697	0.3843	Mempfut	0.0044	0.9475
Whybuy11	0.2473	0.6211			

Categorising cases into those which had replied within the median response time and those that had not, these showed except in the case of one motivational factor (WHYBUY3, lack of opportunity within the company) that there had not been significant differences between the means of the selected variables. The sample could therefore be considered reasonably robust in terms of this particular consideration.

The questionnaire was designed to obtain as much qualitative and quantitative information about the buy-in managers and their companies as possible. To make the questionnaire appear more user friendly, coding columns and codes were not printed on the forms, but a wide enough space left for the author to insert codes after the questionnaire had been returned. 353 variables for each buy-in were used, the author entering the data into SIR/FORMS. Analysis was initially

carried out using SIR/SQL+ AND SIR/DBMS packages (Chapters 6-11). In addition to information gathered from the survey, other variables relating to the companies which were already held on the database, such as financial structuring, were accessed inter-actively.

For statistical testing and interpretation of the Survey results including factor and cluster (Chapter 12) and discriminant analysis (Chapter 13), the data were transferred to SPSS-X, the Social Science Statistical Package (SPSS 1985).

In analysing the management buy-in results, comparisons are also made with data collected in a survey carried out in 1987 of buy-outs completed in 1983-85 (see eg, Wright, Normand, Robbie 1990, Wright, Thompson, Robbie, 1992). The questionnaire for that survey had been designed by the author under the supervision of Wright and Coyne; survey administration and data entry was carried out by the author. Further comparisons are made with other published surveys in areas which were considered relevant, eg sharpbenders (Grinyer, Mayes and McKiernan, 1988), turnarounds (Slatter, 1984) and new ventures (Cooper, Woo and Dunkelburg, 1989).

4.4 The Buy-in Case Studies

While the quantitative results contained in the survey are considered to be of considerable importance, the large number of changes taking place in a company as the result of a buy-in (eg the new change in ownership, the equity incentives for managers, the leverage effect, the influence of the venture capitalist, new advisers and changing external economic factors) makes it difficult to assess the impact of individual variables and in particular the direction of causation. To gain further insight a series of case studies was examined. Although case studies can be used in themselves to build theory which may be likely to have important strengths such as novelty, testability and empirical validity which arise from the intimate linkage with empirical evidence (Eisenhardt 1989) this Thesis follows the more usual approach of using case studies to test the validity of theory. As such it is important to recognise (Scapens 1990) that case studies are

concerned with explanation rather than prediction (see Llewellyn 1992 and Scapens 1992 for further debate on the role of case studies).

Green and Berry (1991) have warned of the dangers of applying quantitative techniques in the complex situations of management buy-outs and note that economic models commonly used to delineate the pre-conditions for a buy-out seem deficient in their behavioural assumptions and unable to account fully for what was observed in practice. Much US analysis of buy-outs appears to have been carried out using quantitative statistical techniques on large samples without specific reference to the individual companies forming the dataset (eg Kaplan 1991, Smith 1990). On the other hand there have been studies involving case studies of individual companies (eg Magowan 1989, Bruner and Eades 1992) which provide little quantitative background. In the UK various books have included illustrative groups of buy-out case studies (eg Kreiger 1990, Clutterbuck and Devine 1987, Wright, Thompson, Chiplin, Robbie 1991, Wright and Robbie (ed) 1991). Important elements of research on turnaround have relied heavily on an approach which has had a high case study element, eg Zimmermann (1991). Baker and Wruck (1989) note that large sample performance studies do not actually document any organisational changes resulting from a buy-out and cannot therefore explore the organisational links between buy-outs and improved economic performance. Documenting these organisational links is essential to understand the mechanisms by which changes in a firm's financial structure affect organisational performance.

This thesis attempts to provide a blend of the advantages of a mixture of quantitative research with the case study approach. The use of case studies involving in-depth interviews was therefore employed to provide a necessary qualitative element to the research for the thesis and to test initial hypotheses which had emerged from the frequency distribution analysis of the survey. After careful examination of the representativeness of individual respondents, a series of case study interviews was held in the period November 1990 to January 1991 with selected respondents. A sequence of selecting suitable cases, preparation, collecting evidence, assessing evidence,

identifying and explaining patterns, theory development and report writing was followed (Scapens 1990). These cases were selected from the respondents on the basis of illustrating problems and issues which had been identified as well as representing the diversity of sources from which buy-ins may emerge. Thus cases from privately owned companies (including a previous buy-out), divestment from both a UK and overseas controlled company and a buy-in by a dedicated Management Buy-in fund of a quoted company leading to a 'going private' transaction were included. Additionally emphasis was placed in selection on exit characteristics.

Semi structured interviews lasting 2-3 hours were held on site with the Team Leader (and where appropriate other Team Members) to discuss issues relating to the buy-ins in more detail and were followed up, where necessary, by further telephone interviews to check new issues which had emerged. Performance of the cases was subsequently monitored allowing for instance for subsequent financial restructuring to be included. Case study issues are summarised in Chapter 14 with detailed cases shown in Appendices 7-12.

CHAPTER 5

GENERAL CHARACTERISTICS OF MANAGEMENT BUY-INS

5.1 Introduction

Chapter 2 illustrated the various forms which corporate restructuring may take and showed the relevance of management buy-outs and buy-ins. In the UK these two components since the early 1980's have become an important elements of the overall market for corporate control. By the First Half of 1992 they accounted, together, for over half the number of transactions in the market for corporate control (Chiplin, Wright, Robbie 1992). Within the buy-out sector management buy-ins developed rapidly from the mid 1980's and by 1989 when accounted for over half the buy-out market value. While their value has subsequently fallen, the number of transactions still remains significant. Importantly the development of buy-ins followed that of buy-outs and it was not until the latter were themselves well established that interest became shown in buy-ins.

This chapter follows the development of both the public and private management buy-in in the UK, examines the reasons for their growth and assesses the general characteristics of the population of buy-ins compiled by the author and held on the CMBOR database (Chapter 5.2). Comparisons are then made with management buy-outs (Chapter 5.3) to test the hypotheses concerning differences in terms of sources, sizes, regional and industrial distributions, financing structuring, pricing and realisation hypothesised in Chapter 3.

5.2 Development of the UK Market for Management Buy-ins

During the 1980's the UK management buy-in market showed more erratic patterns of growth than management buy-outs (Table 5.1), significant numerical growth happening each year from 1985 onwards but values fluctuating; a peak in terms of both volume and value (148 and £3,614mn

TABLE 5.1: UK MANAGEMENT BUY-OUTS AND BUY-INS

Year	Buyouts			Buy-ins			Total		
	Number	Value (£m)	Ave Value (£m)	Number	Value (£m)	Ave Value (£m)	Number	Value (£m)	Ave Value (£m)
1979	18	14	0.8	1	1	0.5	19	14	0.7
1980	36	28	0.8	0	0	0	36	28	0.8
1981	143	180	1.3	6	24	4.0	149	204	1.4
1982	237	347	1.5	9	317	35.2	246	664	2.7
1983	235	366	1.6	10	9	0.9	244	375	1.5
1984	237	403	1.7	6	5	0.8	243	408	1.7
1985	263	1,142	4.3	30	41	1.4	293	1,183	4.0
1986	315	1,175	3.7	51	316	6.2	366	1,491	4.1
1987	344	3,215	9.3	90	306	3.4	434	3,521	8.1
1988	375	3,712	9.9	113	1,216	10.8	488	4,928	10.1
1989	373	3,887	10.4	148	3,614	24.4	521	7,501	14.4
1990	484	2,456	5.1	110	654	5.9	594	3,110	5.2
1991	446	2,155	4.8	119	674	5.7	565	2,829	5.0
1992	445	2,554	5.7	134	710	5.3	579	3,264	5.6

respectively) was reached in 1989, also the peak year for management buy-outs and the total market for corporate control.

A major reason for this unsteady pattern of value growth has been distortion caused by the presence of a few very large public buy-ins, for instance the Paternoster bid for Woolworths (£310 mn) creating a total buy-in value for 1982 which was not to be exceeded until 1988 despite the growth in volume of deals (Table 5.2).

TABLE 5.2: NUMBERS AND VALUES OF MANAGEMENT BUY-INS											
Type	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Private											
No.	4	8	5	23	25	47	85	119	96	112	126
Value (£m)	2.8	8.2	4.2	20.3	80.5	193.8	606.9	495.8	559.9	639.6	679.2
Ave Value (£m)	0.7	1.0	0.8	0.9	3.2	4.1	7.1	4.2	5.8	5.7	5.4
Public											
No.	5	2	1	7	26	43	28	29	14	7	8
Value (£m)	313.8	1.2	0.8	20.2	235.7	111.8	609.2	3118.3	94.0	33.9	31.1
Ave Value (£m)	62.8	0.6	0.8	2.9	9.1	2.6	21.8	107.5	6.7	4.8	3.9
Total											
No.	9	10	6	30	51	90	113	148	110	119	134
Value (£m)	316.7	9.4	4.9	40.5	316.2	305.7	1216.2	3614.2	653.9	673.6	710.3
Ave Value (£m)	35.2	0.9	0.8	1.4	6.2	3.4	10.8	24.4	5.9	5.7	5.3

The broader based private management buy-in has shown a steadier trend.

The development of the market for management buy-ins during the 1980's can be seen within a larger framework of influences covering the generation of opportunities, the infrastructure to complete deals and the possibilities for the realisation of gains (see eg Wright, Thompson, Robbie 1992). The generation of opportunities will be heavily influenced by attitudes to entrepreneurial risk (and hence the willingness of managers to leave their existing jobs and buy equity in another), the ownership structure of industry (and hence the availability of entities which are for sale) and the state of development of mergers and acquisitions markets. The infrastructure to complete transactions (Chapter 2.4) includes the suitability of legal and taxation frameworks, the availability

of both venture capital and banking finance and the development of a professional adviser and intermediary infrastructure to identify, negotiate and provide general advice on buy-ins. Consideration for the possibilities of realisation of gains includes the existence of suitable exit routes such as stock market flotation, trade sales, secondary buy-out or buy-in and other forms of restructuring (see Chapter 2.6.6). As will be shown below the U.K. in the mid to late 1980's provided these necessary conditions.

The buy-in market in the early 1980's was characterised (excluding the exceptional Paternoster/Woolworths buy-in) by an annual volume of less than ten management buy-ins, low values and more private than public buy-ins. Only a handful of venture/development capital institutions such as ECI Ventures and 3i appeared interested in this market. Nevertheless several important buy-ins were completed involving venture capitalists. Among partial public buy-ins of this period, two outstanding examples of companies which were to expand with great success in the later 1980's were Albert Fisher and Williams Holdings (Lorenz and Wansborough, 1987).

In terms of the framework described above, the early 1980's were a period of severe economic and political adjustment after the 1970's and with the growth and stability of the late 1980's far from apparent. The venture/development capital industry was still relatively small, there was continuing concern as to the availability of finance for small companies and what was to be seen as the Enterprise Culture was still underdeveloped. The role of external new management in restructuring companies at the beginning of the 1980s was neither a common occurrence nor was accompanied by the management (in a still relatively highly taxed environment) taking an equity participation. Companies were still only slowly coming to terms with divestment opportunities (Chiplin and Wright 1987). Stock Market prices were low and there were severe limits on the ability of companies to raise new finance through rights issues or other methods of placing. Interest rates were high. Coupled with low PE ratios, there was a severe limit on companies being able to divest at satisfactory prices. However recession in itself produced a need for groups to be

restructured as well as producing a series of significant bankruptcies. Under-performing subsidiaries were frequently retained rather than sold or occasionally sold quietly to incumbent management and the external management brought in was usually in the form of the 'company doctor'. Increasingly as the 1980s developed these specialists were being offered the advantages of share option schemes in quoted companies as a result of legislation passed in the late 1970's and refined in the 1980's. Management buy-outs from 1982/83 onwards raised the profile of the trained manager who felt he had entrepreneurial abilities and illustrated the benefits to be had for institutions in backing companies where management had the incentive of equity ownership. By the mid 1980's however the country's economic and financial circumstances had changed very significantly; strong growth was following the severe recession, there was a rising stock market, managerial remuneration packages were becoming more performance orientated, there had been major changes to personal income and capital gains taxation systems and the increasing incidence of employee share ownership schemes made management more attuned to the advantages of equity stakes in a general context. There was also a need for certain conglomerates to reverse earlier diversification policies. At the same time the evolution of the management buy-out marketplace was successfully resulting in significant funds becoming available for investment in companies where management were seen as key in establishing a successful independent company.

A clear take-off point for management buy-ins can be seen occuring in 1985/86. While 1985 brought significant volume expansion and also further examples of institutionally backed public buy-ins (eg Cullens), in 1986 there was considerable deepening of the market for both public and private buy-ins. Reflecting the rapidly changing nature of the London stock market as the run-up to regulatory moves got underway, executive teams were becoming more active in identifying target companies, frequently as a means to enter a turn-around situation where new management would be so welcomed that major capital raising exercises in a rapidly rising stock market could quickly transform the company and create rapid growth through acquisition. On a more substantial basis were the 1986 buy-ins of Gestetner (by Australian entrepreneurs, £140 mn market

capitalisation) and Macarthy (£36.6 mn). The value of private buy-ins rose sharply and included such key deals as Haleworth (£20 mn) led by Philip Ling, a key person behind the 1985 Haden buy-out, the first UK 'going private' buy-out, a case of the buy-out manager subsequently going on to lead a buy-in.

Growth by now reflected the different stages of the economic cycle and the increasing entrepreneurial nature of management. Changes in banking focus also helped as banks sought emerging corporate clients and changed lending emphasis. Rapid rises in the stock market heightened interest by both management and financiers to the potential capital gains which could be obtained by the successful injection of new management into under-performing companies. For private buy-ins, development capital companies were enjoying a highly profitable and growing mbo market and were keen to extend their interests into relatively similar areas sensing signs that the management buy-out market was showing signs of maturity (Hutchings 1987). Despite the increasing attention being given to the possibilities for buy-ins, considerable practical difficulties were still being encountered in some of the more ambitious public buy-ins. Indeed comparison can be made with the issues facing hostile LBO attempts in the United States. This was particularly seen in the failure by institutions and a new management team to acquire Simon Engineering.

Despite the well publicised failure of this bid and the problems raised at the time about this style of transaction, 1985 and 1986 had provided the vital turning point in the development of the UK management buy-in market. In 1987 there was a very significant increase in volume of buy-ins to 90, of which almost half was accounted for by public buy-ins the majority of these being partial bids rather than taking the company private from the stock market. Despite an almost doubling of volume in a year to 90 transactions, the actual value of buy-ins in 1987 declined marginally to £306 mn. As stock markets reached a peak during 1987, the psychology of managers in seeking to acquire effective management control of quoted companies as well as the financing possibilities

given entry Price Earnings ratios in their 20's began to falter. While many private buy-ins continued to be relatively small and from privately owned sources, a significant development at the end of the year was the buy-in of the bearings division of RHP (United Precision Industries, £73.5 mn). This was the first private buy-in of a major division of a quoted company. The size and publicity given to this tranactions highlighted the opportunities available for successful divestment by quoted companies of subsidiaries and divisions to external management. Despite the economic and financial uncertainties which arose in the immediate aftermath of the October 1987 stock market crisis, early 1988 buy-ins included Cope Allman/Quoteplan, £265 mn financing and the largest private management buy-in to date and Lewis's Department Stores from Sears, £74 mn; these emphasised the changing nature in corporate restructuring of the private buy-in as it developed from relatively small companies where the vendor was predominantly an individual faced with family succession problems to divestment of subsidiaries of major quoted companies. 1988 also marked the first year when volume exceeded the 100 transactions and £1,000 mn value barriers. As well as the two large private buy-ins referred to earlier, several took place in the £10-20 mn value range. Additionally in some others initial financing requirement were lower but significant additional funds were committed at the time of buy-in to future expansion. Furthermore public buy-ins, although themselves down in volume reflecting the changing opportunities on the stock market, were at a record value, principally influenced by the buy-in of the Harris Queensway chain of furniture retailers. At £446.8 mn the Lowndes Queensway buy-in was then a record size (in current values) for a buy-in and was made against management efforts to launch a rival management buy-out going private bid.

In 1989 buy-in values virtually trebled to £3,614 mn, significantly increasing their relative position to buy-outs, accounting for 28.4 percent of all buy-out and buy-in transactions (Table 5.3) compared to 23.2 percent in 1988 and almost half of the value of all deals (48.2 percent) virtually double that of the previous year. This however should be seen against the record levels reached

TABLE 5.3: BUY-INS RELATIVE TO THE BUY-OUT AND OVERALL MARKET FOR CORPORATE CONTROL						
	Buy-ins as a proportion of total buy-out markets (%)		Buy-ins as a proportion of market for corporate control (%)		Buy-outs and buy-ins as proportion of market for corporate control	
Year	Number	Value	Number	Value	Number	Value
1982	3.7	47.7	1.3	11.0	34.7	23.1
1983	4.1	2.4	1.4	0.0	35.4	13.8
1984	2.5	1.3	0.7	0.0	30.0	6.9
1985	10.2	3.5	3.9	0.0	38.2	14.3
1986	13.9	21.2	4.2	1.9	30.3	8.8
1987	20.7	8.7	4.6	1.5	22.1	17.6
1988	23.2	24.7	5.7	4.4	24.6	17.7
1989	28.4	48.2	7.9	10.4	28.0	21.6
1990	18.5	21.0	8.0	5.7	43.3	27.2
1991	21.1	23.8	11.1	5.1	52.6	21.3
1992	23.1	21.8	13.2	7.7	57.2	35.4

for the value of all mergers and acquisitions in the UK in 1989 when all types of acquisitions except sales of subsidiaries to other groups reached a peak. Buy-ins accounted for 10.4 percent of the total value of the UK market for corporate control, a level only exceeded in 1982 (11.0 percent) in the unusual circumstances of the Paternoster bid.

Sources of buy-ins became much more varied, extending beyond public buy-ins of quoted companies and buy-ins of family owned businesses which characterised early growth in the market. In particular the trend seen in early 1988 continued into 1989 with subsidiaries of larger groups becoming more evident as sources for transactions. While the number of public buy-ins was little changed in 1989 from 1988, their value increased more than five times to £3,118.3 mn as a result of a small number of exceptionally large transactions.

TABLE 5.4: MAJOR MANAGEMENT BUY-INS (TO JUNE 1992 IN CONSTANT (JUNE 1992) PRICES)				
Buy-in	Source	Year	Current Price	Constant Price
Isosceles/Gateway	quoted	1989	2,157	2,262.9
Kingfisher/Woolworths	quoted	1982	310.0	1,131.0
Pembridge Inv/DRG	quoted	1989	697	757.8
Lowndes Queensway	quoted	1988	446.8	557.8
Quoteplan/Cope Allman	divestment	1988	265	354.2
Gestetner	partial; quoted	1986	140	207.6
Jarvis Hotels	divestment	1990	186.0	192.9
Utd. Precision Instruments	divestment	1987	73.5	104.9
Brunner Mond	divestment	1991	101.5	101.2
Brightreasons II	divestment	1991	94.5	98.4
Lewis's Dept. Store	divestment	1988	74.0	96.9
James Neill	quoted	1989	78.0	84.6
Square Grip	divestment	1989	68.0	83.9
Libbey-St Clair/Ravenhead	divestment	1990	75.2	83.2
Mountleigh	partial; quoted	1989	70.4	76.5
Crockfords Clubs	divestment	1989	61.5	68.8
Macarthy	partial;quoted	1986	36.6	65.0
Enterprise Inns	divestment	1991	62.0	59.0
Financial Insurance	divestment	1988	40.0	50.3
Salt Union	divestment	1992	48.5	48.5
Needwood Holdings	divestment	1988	38.5	48.1
David Brown Corporation	family	1990	45.2	46.0
Spotlaunch	quoted	1990	42.0	45.4
Unicorn Abrasives	divestment	1992	44.0	44.2
First Corporate Shipping	privatisation	1991	42.2	42.0

The largest buy-out/buy-in transaction in 1989 and to date (Table 5.4) was the hostile buy-in of Gateway through Isosceles (£2,157 mn) which highlighted some of the major changes affecting the buy-out market at that point: the increasing aggressiveness of deals as shown in pricing and financial leverage and the need to sell down/unbundle assets within a relatively short time to reduce banking facilities to more acceptable levels The contrasting bids for Isosceles showed the

growing influence of US leveraged buy-out techniques. Later in the year the Pembridge Investments bid for the printing group DRG (£697 mn) involving equity participation from various US and European specialist financiers and accompanied by a proposed large unbundling programme brought further likenesses to the US style LBO. A contrasting type of public buy-in but again reflecting the type of deal illustrated by Jensen in his description of the LBO Association was James Neill (£78 mn) where the MMG Patricof European Buy-in Fund took the company private, installed some of its own senior management and added others as well as intending to significantly expand the business into a major European company. 1989 also saw the launching of what would have been the largest LBO/buy-in or takeover transaction ever carried out in Europe with the Hoylake bid for BAT Industries; this £13,419 mn bid was highly dependent on the unbundling of assets and subsequent demergers, a process which the incumbent management reactively then set about to do as a takeover defence resulting in the lapsing of the bid in 1990.

In contrast private buy-ins however declined in value in 1989 to £495.8 mn despite a further significant volume increase to 119, the largest transaction being Square Grip (£68 mn). Despite this decrease in value, the interest in private buy-ins was high and there was evidence of a further widening of sources away from family succession to divestments from UK quoted companies (Chiplin, Wright, Robbie 1990). Many venture and development capitalists were now actively promoting the management buy-in as an alternative form of corporate restructuring (eg the 3i management buy-in programme received much publicity and support from managers who were interested in this type of venture) and MMG Patricof had launched a European orientated fund exclusively aimed at large management buy-ins. Institutions faced with an increasingly competitive management buy-out market were also attracted to the buy-in as an investment form. Although buy-ins were perceived to have a greater degree of risk than management buy-outs, this was felt to be adequately compensated for the institution through higher projected internal rates of return (De Quervain 1989). Early realisation rates appeared to support this view.

Five years' rapid growth came to an abrupt halt in 1990. Changing economic and financial circumstances, concerns over high leverage, over pricing and an increasing number of receiverships a different attitude towards buy-outs as a whole by debt providers, and the risk element within buy-ins pushed the value for the year down to only £653.9 mn with volume declining to 110 buy-ins. The public management buy-in market collapsed with only two major transactions (Spotlaunch and Aircall, both of which were at the time only traded through stock market Section 535 provisions rather than having a quote on one of the three London markets) while the value of private management buy-ins actually increased. However a significant element of this value was accounted for by two deals, the buy-in of Jarvis Hotels, a divestment from Allied-Lyons, £186 mn and David Brown Corporation, then the largest privately owned company to be sold through a buy-in, £45.2 mn.

This decline in activity levels contrasts with the buoyant volume of management buy-outs although it follows the sharp decline in the overall UK mergers and acquisitions market. While 1989 had represented a peak level of activity for buy-ins, it also symbolised a major break in the development of the market. After the rapid economic growth of the 1980's, a major deterioration in economic and financial background was evident. Assumptions behind business projections were not so clear cut especially for transactions which necessitated major improvements in performance. The malaise of some large buy-out deals in the US and UK bore heavily on the health of the market; concern was felt at leverage levels as the period of high interest rates became longer and companies began to struggle in the face of these and declining levels of economic activity. Some buy-ins had clearly been completed at prices which in retrospect seemed too high. It was also apparent that while there had been significant success for a substantial proportion of early buy-ins, some completed in the late 1980's appeared not to be faring so well; in particular those (such as Isosceles, DRG, Lowndes Queensway) which involved the subsequent unbundling of a significant proportion of the target's assets found disposal projections difficult to achieve. By 1990 receiverships of buy-ins were comfortably exceeding trade sales on a cumulative basis (Chiplin,

Wright, Robbie 1991). The Lowndes Queensway buy-in entered receivership after refinancings and at the end of 1990 Isosceles announced details of a major refinancing; both buy-ins had failed to achieve the degree of turnround anticipated or the divestitures which had been in their original Business Plans.

The year 1991 was one of contrasts for UK buy-ins. Activity levels in the early months were extremely depressed reflecting growing concern as to the health of existing buy-ins, declines in commercial bank senior debt availability and the poor econonic and financial outlook. As the year progressed opportunities began to re-emerge as company prices remained low, corporate performance was felt to be nearing the bottom of the cycle and opportunitues arose to buy companies at more realistic levels. These included the purchase of assets from receivers. A further opportunity arose through certain brewery groups being forced to divest public houses as a result of the MMC Commision Report on the Brewing Industry. These were felt to be attractive for management buy-ins involving the creation of new groupings and resulted in some large transactions in the second half of the year. Consequently for the year 1991 private management buy-ins rose to a record value of £639.6 mn with volume recovering to 112, only seven short of that in 1989. Public management buy-ins, with PE ratios of quoted companies remaining very high, were relatively insignificant resulting in a total of 120 public and private buy-in transactions worth £676.1 mn for the year. In 1992 further volume growth was seen with value increased compared to 1991.

Putting the growth of management buy-ins into the context of the overall buy-out and corporate control markets, different patterns emerge in terms of volume and value. The proportion of buy-ins in the overall market for corporate control as measured by number of deals identified has increased every year since 1984, reaching its highest level in 1992 at 13.2 percent of the total (Table 5.3). By value, however, the market peaked in 1989 with the large buy-ins of Isosceles and DRG, although it did not return to 1988 levels. This trend is partially reflected in an examination

of buy-ins as a proportion of the total buy-out market. This shows a significant reduction in the relative importance of buy-ins occurring in 1990 although there has subsequently been some recovery, especially in volume (Chiplin, Wright, Robbie 1992).

Putting the UK buy-in experience into a European perspective, the UK remains the largest single market for management buy-ins although there are signs of the development of this type of transaction in several continental countries (see eg Clutterbuck, Snow, Robbie, Wright, 1990; Robbie, Wright, 1991). In France there have now been several significant buy-ins including La Cotes Desfosses and the public buy-in of Pier Import in 1988. Significantly several UK development capital institutions have been involved in leading the funding of some of these transactions. Although these buy-ins have come from several types of source, the need to create opportunities to facilitate the transfer of ownership held by families and founders of private firms is seen as a major element in the future development of buy-ins in France and some other continental countries. In Italy the overall buy-out market is small but the proportion of deals represented by buy-ins is high (about 40 percent) as external management takes advantage of succession or restructuring problems in the SME sector and in particular fills the managerial vacuum caused by the strong entrepreneurial owner (Carulli, Robbie 1992). Management buy-ins have emerged as one of the forms for restructuring in the former GDR and may provide an effective way for the transfer of management experienced in western markets into units where incumbent management were not exposed to market economies (Robbie, Wright 1991).

5.3 Basic Differences in Characteristics between Buy-outs and Buy-ins

In view of the basic differences hypothesised to exist between buy-outs and buy-ins, statistical comparisons have been made between the two types to identify both basic demographic backgrounds to transactions but also the existence of expected differences and to test for statistical significance. The sample for this discussion is derived from the basic database developed for the Centre for Management Buy-out Research; in view of the small numbers of buy-ins

completed in the early 1980's, the period taken for the comparisons in this Section is 1986 to 1991 (except where otherwise stated), providing a total sample of 487 private buy-ins and 2,374 buy-outs. Public buy-ins are excluded.

Identication of differences between management buy-outs and management buy-ins in terms of size and pricing, source, industrial sectors, regional location, financial structuring and exit routes is made. Where appropriate Chi-Square tests are carried out between the sample of management buy-outs and buy-ins to determine whether statistical differences exist between management buy-outs and private management buy-ins (Table 5.6).

(i) Size Distribution and Pricing

Management buy-ins have tended to be smaller in size than management buy-outs (Table 5.5). Of the three categories into which size distributions have been made for buy-ins over £5mn, only that for the size range £10 to 25 mn showed a higher proportion of buy-ins than buy-outs. Less than 5 percent of buy-in were for over £25 mn compared to 6.7 percent for buy-outs.

TABLE 5.5: SIZE OF BUY-OUTS AND BUY-INS

Value Range	Buy-out (%)	Private Buy-in (%)	Total (%)	Total (Number)
Less than £1m	41.5	42.9	41.8	913
£1m - £2m	17.1	20.5	17.7	387
£2m - £5m	18.8	18.3	18.7	409
£5m - £10m	9.1	5.5	8.4	184
£10m - £25m	6.8	8.0	7.0	154
More than £25m	6.7	4.8	6.3	138
Total	100.0	100.0	100.0	2185
Sample	1770	415	2185	

The Chi-Square test used to identify statistically significant differences between buy-outs and buy-ins (Table 5.6) failed to produce statistically significant results for value range distributions (Chi-Square=9.867, p=0.08).

TABLE 5.6: DIFFERENCES BETWEEN MANAGEMENT BUY-OUTS AND PRIVATE BUY-INS					
	Region	Activity	Source	Size	Exit
Chi-Square					
Chi-Square	12.30	124.27	153.73	9.867	41.51
Significance	0.197	0.000	0.000	0.079	0.000

The lower values of private buy-ins may reflect buy-ins being priced at lower levels than buy-outs to take account of perceived differences in risk factors, eg the problems of asymmetry of information when negotiating with the vendor. Additionally whereas in a management buy-out three critical elements- proven market, proven product and proven management- are being acquired, in a buy-in the proven elements are confined to the products and market (Shaw, 1987). It can also be hypothesised that following the emergence of large refinancings and indeed failures from 1989, buy-in pricing would decrease.

TABLE 5.7: PRICING OF BUY-OUTS AND BUY-INS						
Year	Deal Value/Operating Profit					
	Buy-outs			Buy-ins		
	Average	STD	Sample	Average	STD	Sample
1989	10.63	19.29	46	8.14	4.22	24
1990	7.24	5.52	81	7.38	6.60	23
1991	6.51	4.19	60	5.70	4.40	24

Table 5.7 shows Price Earnings ratios for buy-outs and buy-ins in the period 1989 to 1991 (operating data for earlier periods was not collected by CMBOR). Earnings have been based on operating profit before interest and taxation while the value is the deal rather than financing value. The Table shows a steady fall over the three years and with (apart from 1990) the PEs of

buy-ins being below those for buy-outs. Overall figures for PE ratios have been difficult to identify although 3i have confirmed recent falls for buy-out investments, eg the post tax historic PE being an average of 7.5 in 1989-91 for buy-outs, but 6.1 in 1991 (3i 1992b).

(ii) Source Distribution

As described in the earlier sections on corporate restructuring, buy-outs and buy-ins may come from six major sources, divestment, privately owned companies, receivership, private/family ownership privatisation and going private. In view of the non inclusion of public buy-ins in this analysis, going privates are excluded from this statistical examination.

TABLE 5.8: TYPE OF SOURCE OF BUY-OUTS AND BUY-INS

Source	Buy-out (%)	Private Buy-in (%)	Total (%)	Total (Number)
Receiver	7.4	7.8	7.5	193
UK Divestment	50.7	29.8	47.7	1230
Non-UK Divestment	9.5	4.0	8.7	225
Private	26.8	57.8	31.3	807
Privatisation	5.4	0.5	4.7	122
Total	100.0	100.0	100.0	2577
Sample	2205	372	2577	

Source distribution of private management buy-ins shows a heavy bias towards previous family/private ownership (Table 5.8), although this proportion has been declining for some years (Chiplin, Wright, Robbie 1992). However buy-ins of private/family companies have generally been relatively small. Consequently while divestments have accounted for a minority of buy-in volume, they have accounted for the majority of the value since the late 1980's, with family and privately owned source accounting for only 16.4 percent of value in 1991. The largest buy-in of a privately or family owned company was David Brown Corporation in 1990 but this was the 22nd largest buy-in of all time with 13 divestment buy-outs greater in size (Table 5.4). Until 1991 receivership

as a source had been relatively insignificant; incumbent management has a significant advantage in this type of situation and the need to be able to complete a deal quickly before the business starts to wind down causes serious due diligence problems for the buy-in team and its backers. Despite such considerations, this source grew significantly in 1991 to account for 19.3 percent of private buy-ins, although on a cumulative basis the proportion for buy-ins was little different than for buy-outs.

Privatisation as a buy-in source has been relatively less important than for buy-outs, the two most important being Gleneagles Hotel from British Transport Hotels and in 1991, First Corporate Shipping Services, the buy-in of the Port of Bristol.

Statistical testing of the source of buy-ins compared to buy-outs produced significant differences (Chi-Square=153.7, p=0.000 and Table 5.6) and help to confirm buy-ins as a means of achieving succession in privately owned companies rather than a method of divestment of divisions or subsidiaries of quoted companies.

(iii) Industrial Classification

Almost one quarter (24.4 percent) of private management buy-ins are in retail and wholesale distribution compared to 14.8 percent for buy-outs (Table 5.9).

The most important single sector is retail distribution (especially motor distribution) followed by business services, mechanical engineering and wholesale distribution. The attractiveness of management buy-ins for the motor distribution industry reflects the homogeneity of the industry whereby, say, a Managing Director of a Ford dealership can be placed in a dealership elsewhere with low risk. Sectors with a notably higher incidence for private buy-ins than buy-outs are retail distribution and hotels and catering. Smaller differences were noted for mechanical engineering, paper, printing and packaging. Sectors where buy-ins appear very under-represented are Business

TABLE 5.9: ACTIVITY OF BUY-OUTS AND BUY-INS				
Activity	Buy-out (%)	Private Buy-in (%)	Total (%)	Total (Number)
Agriculture, energy	0.8	1.5	0.9	25
Food	3.4	3.6	3.4	96
Chemicals	2.3	2.1	2.2	63
Metals	3.6	4.4	3.7	105
Mechanical engineering	8.9	10.1	9.1	257
Electrical engineering	9.8	6.7	9.3	261
Shipbuilding, vehicles	2.6	3.2	2.7	77
Textiles	2.3	1.1	2.1	60
Leather, footwear	2.4	2.7	2.5	70
Non-metallic mineral manufacturing	1.5	1.7	1.5	43
Timber, furniture	3.2	3.2	3.2	90
Paper, printing	6.5	7.6	6.7	189
Other manufacturing	3.8	4.2	3.9	109
Construction	4.4	1.5	3.9	109
Transport	5.7	3.4	5.3	149
Wholesale distribution	9.4	9.9	9.5	268
Retail distribution	5.4	14.5	7.0	196
Business services	18.1	12.6	17.2	484
Hotels & Catering	1.2	5.3	1.9	57
Banking, insurance, finance	4.6	1.1	4.0	113
Total	100.0	100.0	100.0	2818
Sample	2342	476	2818	

Services and banking, insurance and finance. These two sectors account for only 13.7 percent of buy-in activity compared to 22.7 percent for buy-outs.

Private buy-ins appear also considerably less likely to occur in electrical and electronic industries, textiles, construction and transport and communication.

Differences between activities of buy-outs and buy-ins appeared significant (Chi-Square=124.37, p=0.00, Table 5.6).

Despite these apparent differences, the distribution of buy-in industries was spread through all major economic and industrial sectors like buy-outs. This gives further credence to the notion that buy-ins in the UK are different in nature from LBOs in the US where there are large concentrations in a small group of mature and cash generative industries (eg Easterwood et al 1989).

(iv) Regional Distribution

The regional distribution of private buy-ins appears to closely follow that of buy-outs (Table 5.10) with the South East of England being the dominant region, as it is in the overall stock of UK companies.

TABLE 5.10: REGIONAL DISTRIBUTION OF BUY-OUTS AND BUY-INS

Region	Buy-out (%)	Private Buy-in (%)	Total (%)	Total (Number)
South East	37.5	36.3	37.3	1047
East Anglia	3.4	3.3	3.4	95
South West	6.1	6.8	6.2	175
West Midlands	10.7	9.1	10.5	294
East Midlands	6.7	9.3	7.1	200
Yorks-Humberside	9.5	8.9	9.4	263
North West	9.2	12.2	9.7	272
North	3.6	3.1	3.5	99
Wales	3.6	3.3	3.5	99
Scotland	9.8	7.5	9.4	265
Total	100.0	100.0	100.0	2809
Sample	2327	509	2809	

The order of regions does differ from that of buy-outs, with the North West and East Midlands being the next most important, accounting for higher proportions of buy-ins than buy-outs. Scotland, a region with a particularly active buy-out market, has markedly lower shares of buy-ins than buy-outs and the West Midlands to a lesser extent.

Despite the different orderings significant differences in the regional composition of buy-ins and buy-outs could not be confirmed (Chi-Sqaure=12.3, p=0.197, Table 5.6).

(v) Financial Structuring

As outlined in Chapter 2.5, buy-ins are structured through the use of equity subscribed by both management and specialist financing institutions, senior debt, mezzanine debt and other forms of finance such as loan notes and deferred payments. Vendors may be involved in providing these forms as well as taking participation in the equity of the new company. Agency Cost theory would imply that structuring in corporate restructuring should provide management with significant equity incentives while high level of leverage will provide debt bonding effects. Different transactions are also unlikely to have identical financing structures, even when finance has been provided by the same institutions, given the unique cash flow, profit forecasts and asset backing of individual target companies. Neverthless general patterns of structuring may be expected to emerge.

As well as identifying the overall deal structuring, size of transactions is seen as an important influence in determining the type of financing package agreed with the venture capitalist and banks. Consequently overall deal structures have been separated into two size ranges- financing value of less than £10 mn and those of at least £10 mn.

TABLE 5.11: UK MANAGEMENT BUY-IN DEAL STRUCTURES

Type of Finance (Average)	Size of Buy-in											
	Less than £10 financing				At least £10m financing				All sizes			
	1989	1990	1991	1989-91	1989	1990	1991	1989-91	1989	1990	1991	1989-91
Equity (%)	37.5	37.1	46.0	39.7	22.1	24.3	28.2	25.2	26.2	26.0	30.5	27.6
Mezzanine (%)	11.2	11.4	9.6	10.7	12.2	7.7	16.1	12.0	12.0	8.2	15.4	11.8
Debt (%)	38.8	29.2	29.3	33.6	56.0	34.9	49.9	45.8	51.3	34.1	47.2	43.7
Loan Note (%)	4.7	15.8	9.6	8.9	9.0	22.0	2.0	11.3	7.7	21.4	2.9	10.9
Other Finance (%)	7.8	6.5	5.5	7.1	0.7	10.9	3.8	5.7	2.8	10.3	4.0	6.0
Total (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Sample financing value (£m)	102	65	62	229	270	415	419	1104	372	479	481	1332
Sample (number)	44	32	31	107	10	10	10	30	54	42	41	137
Within which:												
1. Funding:												
Average vendor contribution (%)	6.5	16.3	4.0	8.4	4.1	7.5	5.4	5.9	4.6	8.8	5.4	6.4
Average management contributions (%)	7.8	9.4	9.1	8.4	2.0	1.5	1.0	1.4	3.6	2.5	2.0	2.7
2. Average proportion of equity held by management (%)	51.5	53.4	61.4	54.6	20.3	37.6	27.3	28.4	45.8	49.8	51.4	48.6

Examining deal structures over the period 1989 to 1991 several important features can be identified (Table 5.11). The average proportion of equity has increased while the share of senior debt has reduced reflecting the need to adopt more conservative gearing policies. However there has been a significant variation between individual years, a sharp reaction in gearing levels occurring in 1990. The proportion of senior debt and mezzanine fell and was accompanied initially by a sharp rise in the use of other forms of finance and especially loan notes. The use of these declined in 1991 but that of mezzanine and senior debt increased. Comparison with leverage rates shown for U.S. buy-out transactions (eg Marais et al 1989, Singh 1990) shows a much lower rate in British buy-ins.

Smaller buy-ins appear to have a different form of financing structure from the large ones. Equity accounts for a larger proportion of finance for the smaller deals, ie they are more conservatively structured, and the use of specialist mezzanine finance is more limited. In particular the increased use of debt and mezzanine finance has been limited to the larger deals and smaller management buy-ins have become comparatively conservatively geared. Management are also likely to have a majority of the equity voting rights in the smaller buy-ins.

Comparison can also be made with management buy-outs (Table 5.12). Here the differences between small and large transactions are also evident, the larger deals using more mezzanine and senior debt than smaller transactions. Overall comparison with management buy-ins also shows buy-outs requiring less equity, confirming the relative risk factors felt to apply.

To gauge the significance of the difference between buy-out and buy-in structures, a series of z-tests were made to identify significant statistical differences. The proportion of debt, equity and mezzanine and other forms of finance were compared for several categories of transactions (Table 5.13). No significant statistical differences were found between buy-outs and buy-ins of less than £10 mn financing; between buy-ins and buy-outs of more than £10 mn financing; between all buy-

TABLE 5.12: UK MANAGEMENT BUY-OUT DEAL STRUCTURES

Type of Finance (Average)	Size of Buy-out											
	Less than £10m financing				At least £10m financing				All sizes			
	1989	1990	1991	1989-91	1989	1990	1991	1989-91	1989	1990	1991	1989-91
Equity (%)	32.5	33.9	43.0	35.6	17.4	24.8	24.0	20.8	18.8	26.5	26.1	22.5
Mezzanine (%)	7.9	7.8	4.1	6.8	17.9	10.4	6.4	13.3	17.0	10.0	6.1	12.6
Debt (%)	46.2	41.0	38.4	42.4	58.7	55.6	44.9	54.6	57.6	52.7	44.2	53.1
Loan Note (%)	3.0	9.5	4.6	5.8	3.4	6.4	11.2	6.0	3.4	7.0	10.4	6.0
Other Finance (%)	10.4	7.8	9.9	9.4	2.6	2.8	13.5	5.3	3.2	3.8	13.1	5.8
Total (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Sample financing value (£m)	247	276	177	700	2632	1175	1222	5030	2879	1452	1399	5730
Sample (number)	81	98	73	252	34	29	25	88	115	127	98	340
Within which:												
1. Funding:												
Average vendor contribution (%)	6.6	7.4	8.1	7.2	5.3	8.2	15.3	8.3	4.9	8.2	13.6	7.9
Average management contributions (%)	7.5	7.8	7.2	7.6	1.3	2.5	1.7	1.6	1.7	3.5	2.3	2.3
2. Average proportion of equity held by management (%)	60.4	57.0	53.2	56.8	32.7	31.7	30.1	31.7	52.0	51.1	48.9	50.8

TABLE 5.13: Z-TEST DIFFERENCES BETWEEN FINANCING STRUCTURES, 1989-91 MANAGEMENT BUY-OUTS AND BUY-INS			
	Equity	Debt	Mezzanine & other finance
Less than £10m financing mbi v. Less than £10m financing mbo	0.74	1.56	0.96
At least £10m financing mbi v. At least £10m financing mbo	0.50	0.83	0.48
All mbis v mbos	1.18	1.88	0.45
Less than £10m financing mbi v. At least £10m financing mbo	1.45	1.23	0.25
Note: none of the z-test produced values with a statistical significance difference of 5 percent or less.			

ins and buy-outs (although differences in the proportion of debt, z=1.88, were almost at the 5 percent significant level); or between buy-ins of less of £10 mn financing and those of at least £10 mn financing. Thus while the average proportions of the major financing instruments points to differences between buy-ins and buy-outs, these are not at a statistically significant level. This would seem to imply that venture capitalists in structuring buy-ins do assume that they require a more conservative financing structure than buy-outs, but do not adjust the structure enough to ensure that they are significantly different.

(vi) Exit

A buy-in's exit will depend on a variety of factors and the governance structure adopted will have a clear bearing on institutional attitudes as to when a desired realisation takes place (Chapter 2.6.5-6). However the achievement of the venture capitalist's returns is dependent on achievement of planned objectives. This may be more difficult than in management buy-outs because of difficulty in carrying out due diligence procedures during the buy-in appraisal and the risk factors involved in assessing management in a different environment- perhaps not even in the same sector, or in a sharply different size of company or in a different region. Attitudes to acceptable levels of risk are dependent on individual assessment by institutions of specific industrial

opportunities and management capabilities. Furthermore despite intentions, buy-in managers may not exit as they originally had intended (cf the case of buy-outs, Wright, Thompson, Robbie 1992).

TABLE 5.14: EXITS OF BUY-OUTS AND BUY-INS				
Exit Type	Buy-out (%)	Private Buy-in (%)	Total (%)	Total (Number)
None	80.5	74.3	79.4	2273
Stock Exchange	1.9	2.3	2.0	57
Trade sale	6.7	3.9	6.2	177
MBO:MBI	0.8	-	0.7	19
2nd stage finance	2.4	4.7	2.8	79
Receivership	7.8	14.8	8.9	256
Total	100.0	100.0	100.0	2861
Sample	2374	487	2861	

The proportion of buy-outs remaining in the original buy-out ownership form on a cumulative basis (80.5 percent) is higher then for private management buy-ins (74.3 percent) (Table 5.14). These percentages mark major differences in type of exit, that of receivership showing a particularly marked variation. Thus 14.8 percent of buy-ins end up in receivership, almost double that for management buy-outs (7.8 percent). The reasons for this high proportion refer to the higher risk profile, the under estimation of the problems of righting the problems inherited in a buy-in at a time of recession, a price which in retrospect may have been excessive and too high a gearing ratio (Robbie, Wright 1992a).

The rapid rise in buy-in activity occurred towards the height of the economic cycle when Mergers and Acquisitions activity was high and companies were selling at historically high Price Earnings ratios. Additionally buy-outs were being financed using high degrees of leverage. Combination with economic recession and high interest rates could be expected to result in severe financial problems for the more marginal companies.

TABLE 5.15: UK PRIVATE MBI EXITS													
Year of MBI	Float*		Trade Sale		MBO/MBI		Receivership**		No Exit**		Total	
	No	%	No	%	No	%	No	%	No	%	No	%
1985	0	0	1	4.3	1	4.3	3	13.1	18	78.3	23	100.0
1986	5	20.0	2	8.0	0	0	2	8.0	16	64.0	25	100.0
1987	0	0	7	14.9	0	0	4	8.5	36	76.6	47	100.0
1988	2	2.4	5	5.9	0	0	25	29.4	53	62.3	85	100.0
1989	2	1.7	5	4.2	0	0	26	21.8	86	72.3	119	100.0
1990	0	0	1	1.0	0	0	10	10.4	85	88.6	96	100.0
1991	1	0.9	0	0	0	0	4	3.6	107	95.5	112	100.0

* Includes USM, Third and OTC markets, reverse-ins and floats which were subject to trade sale etc.

** Includes re-financing

Analysis showing exits of buy-ins by year of Buy-in (Table 5.15) confirms this, with virtually 30 percent of buy-ins which were completed in 1988 going into receivership.

The probability of a successful exit through a Stock Market listing was marginally more for buy-ins than buy-outs. However only ten buy-ins in this period did exit in this way, although some did so highly successfully. Since the end of 1989, flotation activity has increased substantially against the record of management buy-outs. Although in the period 1985-89 only 6 buy-ins were floated (143 buy-outs in the same period), in 1990-92 8 buy-ins were floated compared to 12 buy-outs. Highly successful flotations have included Burn Stewart (£11.5 mn buy-in 1988, capitalisation on listing in 1991 of £83 mn), British Data Management (£15.3 mn buy-in 1989, capitalisation on listing in 1992 £18.3 mn) and National Express (£10.5 mn buy-in 1991, capitalisation on listing in 1992 of £59.4 mn). Another floated buy-in, Pickwick, originally bought for £4.7 mn in 1986, was sold to Carlton Communications for £68.5mn in 1992. The reverse-in technique has also been used relatively frequently compared with buy-outs, eg Haleworth, Kembrey Group, and Hollybush Holdings.

Buy-outs were almost twice as likely to have exited through a trade sale than buy-ins (Table 5.14). Highly successful trade sale exits were however obtained by buy-ins such as UPI Industries (£73.5 mn buy-in in 1987, sold to Nippon Seiko for £203 mn in 1990), Schreiber (bought for £6.8 mn in 1987 and sold to MFI for £41.3 mn in 1989) and Cooper Bearings (£13.5 mn in 1987, sold to Kaydon Corporation for £24 mn in 1991).

Management buy-ins appear to show a greater rate of exit than buy-outs in the short term after which the rate of exit levels off so that after Year 5 a lower proportion of buy-ins have exited than buy-outs (Wright, Robbie, Thompson, Wong 1993). This is consistent with evidence that the failure rate for buy-ins is much higher than for buy-outs. It should, though, be borne in mind that the recessionary conditions of the early 1990's and its impact on both product and acquisitions markets, taken together with the later development of the buy-in market, may have reduced the buy-in exit rate.

TABLE 5.16: OWNERSHIP STATUS OF PARENT COMPANY BY AGE OF MANAGEMENT BUY-IN FOR 529 PRIVATE MANAGEMENT BUY-INS COMPLETED IN THE PERIOD 1981-91

Age of MBI	Total LBO status known at year end	Percentage publicly owned[1]	Percentage Privately Owned[2]
Year 1	514	0.2	99.8
Year 2	487	2.3	97.7
Year 3	348	5.7	94.3
Year 4	260	10.4	89.6
Year 5	169	14.8	85.2
Year 6	105	19.0	81.0
Year 7	62	19.4	80.6
Year 8	39	17.9	82.1
Year 9	18	38.9	61.1

1 A buy-in is considered a public entity if it has
(a) been purchased by and is still owned by any public company, domestic or foreign
(b) it has issued equity to the public and is still a public company as at 31.12.92 or
(c) if it has issued equity to the public and subsequently been acquired by a public company.

2 A buy-in is considered a private entity if the buy-in company is still privately owned, either by the buy-out company or subsequent private buyer.

To understand more fully buy-in longevity, the ownership status of management buy-ins (as at end-1992) completed in the period 1981-91 (Table 5.16) was put into a similar format to that adopted by Kaplan (1991).

This showed a series of small annual falls in those privately owned for the first six years of the MBI ownership form, confirming that buy-ins at this stage of development have yet to achieve rapid realisation for their financial backers, except in a minority of cases. Beyond that a much slower rate applies in years 7 and 8 before a large reduction in Year 9, a result however distorted by a low sample base. Making comparisons with the Kaplan survey and the 1983/85 survey of management buy-outs (Thompson, Wright, Robbie, Wong 1993) shows a much lower rate for buy-ins than buy-outs or the US LBOs used in the Kaplan survey. For example, after year 7, 80.6 percent of buy-ins were still privately owned compared to 71 percent of buy-outs and 56.4 percent of the Kaplan sample.

Statistical tests were carried out between the sample of 1986/91 management buy-outs and buy-ins to determine whether statistical differences exist between exit patterns (Table 5.5). The Chi-Square test confirmed significant differences between the exit patterns of buy-outs and buy-ins (Chi-Square=41.51, p=0.000).

5.4 Conclusions

This Chapter has described the development of management buy-ins in the UK and the contrasting pattern of development between public and private buy-ins. It has shown the growing importance of management buy-ins as a proportion of the overall number of transactions in the market for corporate control. Consideration of the development of buy-ins shows this form of corporate restructuring becoming important some time after that of buy-outs. By the mid 1980's conditions may be seen to have been particularly favourable for this type of transaction. Not only were factors which had helped the development of buy-outs been well established- legal, taxation,

institutional finance, development of appropriate exit routes- but the key element of attitudes towards entrepreneurship had gained more credibility while original participants in the buy-out market were themselves seeking product innovation to counter the growing maturity of the market. Despite this certain characteristics have remained different from buy-outs.

Consideration of differing characteristics between buy-outs and buy-ins has confirmed the hypothesis outlined earlier that significant differences do exist in basic demographic factors between buy-outs and buy-ins in certain, but not all, areas and that the market for buy-ins is heterogeneous. It also has shown that exit patterns of buy-ins have not been satisfactory with a high rate of receivership. This in itself may reflect the particular circumstances of the period 1987/89 when competition among instituitions for deals as the Mergers and Acquisitions market reached a peak and resulted in deals which in retrospect seem over priced and over leveraged (see comparisons with the US, eg Jensen 1991). In particular support was found for two of the hypotheses in Chapter 4:

(a) The regional distribution of private buy-ins is not significantly different from those of buy-outs (H1);

(b) Sources of private buy-ins are significantly different from buy-outs (H2);

(c) Industrial activities of private buy-ins are significantly different from Buy-outs (H3)

(d) Management Buy-ins have lower leverage, lower entry PE ratios and prices than management buy-outs (H4); and

(e) Buy-ins represent a higher risk structure than buy-outs and are aimed for longer life: consequently they will have different exit patterns and be especially prone to receivership (H6).

CHAPTER 6

BACKGROUND OF THE TEAM

6.1 Introduction

The composition, ability and cohesiveness of the team will have a considerable bearing on the success of a new venture (Timmons 1990) or a buy-in. Given that the management, in a buy-in, are new to the company and have quickly to establish control over it, there is a need to ensure that they have the capabilities to do so. Chapter 2.3 has illustrated the many social, cultural, parental, educational and career background factors which influence the entrepreneurial decision (and hence the acceptability of the entrepreneur to the financial backer) while Chapter 2.6.4 has described the importance of the new Manager in turnaround conditions.

The relationship between a manager's entrepreneurial abilities and the experience and professionalism of his management skills are critical to the success of the management buy-in which may result in the buy-in Team Leader coming from a mixture of large companies and more entrepreneurial ventures. As hypothesised in Chapter 3, buy-in Team Leaders may be different in background characteristics to management involved in some other types of venture and development capital transactions and private company owners. Degrees of risk taking by the Team Leader are different ranging from the highly entrepreneurial act of starting a business to the lower degree involved in existing management turning an already established company into a viable independent entity as in a buy-out. The management buy-in may be seen as an intermediate form; the purchase of a company by an outside group of managers involves considerable personal risk taking as well as the initiative in finding the business and the finance in the first place. This will be further supplemented by skills required to develop the business and make radical changes to its operations.

Chapter 2.3 described key factors which illustrate typical entrepreneurial backgrounds: age, wealth, parental occupation, education, managerial experience and previous venture ownership. This Chapter tests propositions concerning the extent of parental business ownership, previous experience of entrepreneurship, level of professional and educational achievement of the Team, the relationship within the Team between General Management and specialist backgrounds.

The Chapter proceeds with its examination as follows:

(a) Personal and Educational background (6.2);

(b) Managerial and Employment Background (6.3);

(c) Business ownership (6.4); and

(d) Composition of the Team (6.5).

6.2 Personal and Educational Background

Managers buying-in cover a wider range of ages with 40 percent of team leaders aged 40 or lower and 31 percent aged between 41 and 45 (Table 6.1).

The need to have been able to create enough wealth to be able to fund personal equity or provide the necessary loan or mortgage collateral makes it more likely that people approaching the 40 year old bracket will have the necessary financial strength. The 60 percent of team leaders of at least 40 years old, however, implies an older age distribution than is normally expected for the founding of new ventures, typically seen as between 25 and 40, the 'free choice' period, (Shapero 1971, Mayer and Goldstein 1961, Cooper 1973 and Howell 1972), also older than the entrepreneurial turning points seen in the careers of USM Chief Executives (Slatter, Ransley and Woods 1988). While the average age in this survey appears around the upper levels of these venture related studies, it is however lower than seen in the analysis of managers applying for the

TABLE 6.1: PERSONAL BACKGROUND OF TEAM
(Private MBI's)

	Chief Executive	"Number Two"
Age		
26-35 (%)	13.8	26.7
36-40 (%)	27.6	24.4
41-45 (%)	31.0	24.4
46-55 (%)	24.1	20.0
Over 55 (%)	3.5	4.5
(Sample size	58	42)
Sex		
Female (%)	1.7	7.1
Male (%)	98.3	92.9
(Sample size	59	42)
Educational Achievement		
MBA (%)	10.7	11.6
University degree (%)	30.4	27.9
Other higher education (%)	16.1	11.6
Professional qualification (%)	19.6	23.3
'A' Levels (%)	10.7	9.3
'O' Levels (%)	7.1	2.3
No formal qualifications (%)	5.4	14.0
(Sample size	56	43)
Nationality		
UK (%)	93.1	97.7
Other (%)	6.9	2.3
(Sample size	58	44)
Occupations of parents*		
Manual (%)	5.8	4.5
Semi-skilled (%)	14.0	20.5
Skilled (%)	12.3	15.9
Professional (%)	47.4	45.5
Small business owner (%)	24.6	15.9
Other (%)	3.5	0
(Sample size	57	44)

3i Management Buy-in Programme, where the average age was 45.33 years with 75 percent being at least forty years old (3i 1992a). Given the weighting of 3i investee companies within the sample, this implies that Buy-in managers financed by other venture capitalists are likely to have been younger. Not surprisingly in view of the lower degree of experience expected 'Number Two's were younger, 51.1 percent aged under 40. In contrast buy-in managers tend to be younger than buy-out managers, the average age of Chief Executives in the survey of pre-1983 buy-outs being 47.6 years (Wright and Coyne 1985) although this age appears to have decreased in the 1980's, the average in the CMBOR 1983-85 survey being 41 years while the average age of directors in 3i financed management in the majority buy-outs in 1988/91 was 42 (3i 1992b), little different from buy-ins. Comparison with purchasers of businesses in Cooper and Dunkelburg (1986) shows only a third of US managers being 41 years or older. Buy-in ages appear to be younger than hypothesised in Chapter 4, where it was felt that the greater need to raise capital may mean that Buy-in Managers were older.

The importance of parental background in encouraging entrepreneurship was expected to produce a large number of white collar parents including a significant element who owned businesses. The latter characteristic is seen as important in determining entrepreneurial attitudes (eg Shapero and Sokol (1982), Pickles and O'Farrell (1987). In their youth these future buy-in managers are likely to have seen what is involved in owning and managing a company and the type of initiative which their parents had to use to keep their business successful. In contrast those with professional backgrounds would be unlikely to have such naturally strong entrepreneurial talents although they may be more aware of the problems of such transactions than non white collar backgrounds. The majority of buy-in managers indeed came from a white collar background. Virtually half the sample had professional parents and a quarter were small business owners. This latter proportion of Team Leaders with parents who were small business owners is lower than in most studies concerned with US new ventures where typically over half will have parents or close relatives who owned a business (eg Shapero and Sokol 1982, Cooper and Dunkelburg 1986) or indeed the over

40 percent recorded in European new ventures (eg Donckels and Dupont 1987 on Belgium and O'Farrell 1986 on Ireland). It is however in line with the 22 percent recorded in Slatter, Ransley and Woods (1988) survey of USM Chief Executives. This proportion can be expected to be lower than for managers buying into a company than for those setting up a company, eg 43 % compared to 50 % in Cooper and Dunkelburg 1986. In contrast only 5.8 percent of the sample claimed to have parents who were manual workers. In comparison Number Twos had a lesser element of small business owner but more semi-skilled parents.

The role of education is also seen as being significant in determining future entrepreneurial actions through reducing the venture funding constraints imposed by personal wealth (Casson 1982) although there is considerable variation as to exactly how significant this is in terms of performance direction (eg Storey (1982) noting that educational qualifications are a necessary but not sufficient condition for entrepreneurial success). As Management buy-ins are relatively large transactions involving managers in extensive negotiations and future working relationships with highly qualified and demanding advisers and venture capitalists, it is possible that the more highly qualified the potential buy-in manager is, the more likely he is to be able to pass the stringent venture screening processes. Good accounting advisers and proven track records can of course mitigate to some extent the disadvantages which a person with few qualifications may feel. Additionally the educational background is going to reflect to some extent the background of the parents and the encouragement given to the pursuit of academic goals.

Over half the sample achieved some form of higher education and over 40 percent either a university degree or MBA (Table 6.1). A major element of those who had not gone on to higher education had achieved professional qualifications (19.6 percent of all Team Leaders and 23.3 percent of Number Two's) and only 12.5 percent of Team Leaders had obtained 'O' levels or had no educational achievements at all. In comparison half of applicants for the 3i Buy-in Programme (3i 1992a) had no formal management or technical qualifications, 11 percent had a MBA degree,

13 percent were members of the British Institute of Management, 12 percent were accountants and 14 percent engineers. Clearly the level of education may be related to the type of business, eg the majority of Team Leaders in a high tech venture can be expected to have at least a first degree (eg Cooper 1973 and Mancusco 1975) although the majority of Team Leaders in more general new ventures may not have attained college education (Cooper and Dunkelberg 1986).

Entrepreneurial literature also suggests important roles for females as well as minority groups such as immigrants (eg Hagen 1960, Brockhaus 1982). This survey, however, indicated very low levels of involvement for either: only one team leader was female and only four had a non-UK nationality. 3i note that in their 1989/91 management in the majority buy-outs, 16 % of the teams included one or more women, compared to under 5 % of UK companies (3i 1992b).

In addition to the Team Leader questions were also asked as to the background of the person he considered to be his 'Number Two'. In general he followed basically similar background patterns but tended to be slightly younger (51 percent being no more than forty), while there were several female Number Two's (7.1 percent). The Number Two's parental background was slightly more diverse with fewer parents having been small business owners (15.9 percent) and more semi-skilled (20.5 percent). While the proportion obtaining a university degree or MBA was very similar, the Number Two had a higher likelihood of having a professional qualification (his/her specific professional skill for the buy-in) and more interestingly having no formal qualification at all (14 percent).

6.3 Managerial and Employment Background

The background of the Team Leader in an entrepreneurial venture may frequently reflect an ability to cover many general areas but with other members of the Team filling skill voids. In some cases where the Team Leader's abilities are technical, other Team members will supplement the Leader with other types of skills background (Timmons 1990).

TABLE 6.2: MANAGERIAL BACKGROUND OF TEAMS (Private MBI's)	Chief Executive	"Number Two"
Managerial Background+		
General Management (%)	81.0	30.2
Sales/Marketing (%)	44.8	25.6
Production (%)	17.3	25.6
Finance/Administration (%)	21.1	48.8
Other (%)	8.8	11.6
(Sample size	57	43)
Immediately previous employer		
Top 500 UK Company (%)	33.9	27.5
Other UK plc (%)	19.7	30.0
UK Private (%)	39.3	32.5
UK Public Sector (%)	0	2.5
Overseas Company (%)	7.1	7.5
(Sample size	56	40)
In same sector as buy-in company		
Yes (%)	74.5	85.7
No (%)	25.5	14.3
(Sample size	47	35)
Period of employment with previous employer		
Mean (years)	7.7	8.3
Median (years)	5.0	7.0
(Sample size	56	40)
Number of previous management jobs		
Mean	3.4	2.6
Median	3	2.5
(Sample size	58	42)

\+ Note may add up to more than 100% because of more than one background, eg. general management & sales/marketing.

Survey questions concerning the managerial and employment background of the Team Leader indicated a person with General Management experience working before the buy-in in a relatively large company where he had been employed for a considerable period and had held several previous management jobs (Table 6.2). Again this indicates further bias towards the professional

manager rather than the traditional entrepreneur, the latter frequently being associated with moving jobs relatively frequently. Team Leaders often had more than one background indicating a move during career progression from a specialist function to general management. Although overall a large majority of Team Leaders (81 percent) had a General Management background, within specific managerial skills 44.8 percent had Sales and Marketing experience, more than twice the level for Finance/Administration (21.1 percent).

In contrast and as might be expected, Number Two's were more likely to possess specific skills rather than general management expertise. Almost a half had a Finance or Administration background. Sales or Marketing and Production each accounted for a quarter of the Number Two's backgrounds. From an examination of the skills of the buy-in managers, the impression emerges, as might be expected, of a complementary team with a leader with extensive general management experience being supported by a Finance/ Administration specialist.

Over half the Chief Executives and Number Two's came from a UK plc, and a third of the Chief Executives from a Top 500 UK company implying that Teams came from parts of relatively large companies; Number Two's tended to work for a lower level plc. This supports the view that many Managers in large companies go through a mid-career crisis in which they rethink their goals and ways of life which may result in the impetus to move from the big company to a more entrepreneurial existence (Scott 1976). Almost two fifths of Chief Executives had been working for a privately owned company. Inevitably there must be difficulties for managers who are moving from a subsidiary or division of a large company where they may have been relying more than they realised on the advantages of large company support. The range of management skills required may have excluded certain which will be necessary in a new private company existence. On the other hand the advantage which a manager in a private company of a similar size to the target company has might be lost depending on the strength of character of the owner and his willingness to delegate management and decision making. With entrepreneurial factors being

lower in the public sector, it is not surprising that in the total sample only one (a Number Two) had been working in this segment.

Background employment stability was indicated through the relatively few number of management jobs which had been held previously and a reasonably long period with the previous employer. As was to be expected from their generally lower ages, the Number Two tended to have had fewer management jobs (a median of 2.5) than the Chief Executive who had typically had three. The period of employment with the previous employer averaged around eight years for both, although the median for team leaders was five years compared to seven years for Number Two's. As is to be expected this is considerably shorter than for management buy-outs: the average period of employment for buy-out Chief Executives with the buy-out company being 12.27 years in the Wright/Coyne (1985) study. This contrasts with experience of new venture start-ups where much shorter periods with preceding employers are common.

6.4 Previous Entrepreneurial Experience

As described in Chapter 2.3.3, entrepreneurs are likely to create several businesses in their lifetime, selling one off and starting another or in some cases re-starting after an initial business has failed (eg Mayer and Goldstein 1961, Ronstadt 1988). Additionally the performance of the company may be expected to benefit from this earlier entrepreneurial experience (Lamont 1972). It can also be postulated that the learning experience of attempting to set-up a buy-out which did not take place may help the process of forming a buy-in. Consequently it is not surprising that a major source of buy-in managers has been suggested as either people who have owned a company (perhaps through a buy-out) and subsequently sold out but want to repeat the process or alternatively who may have been part of a buy-out attempt which was not successfully completed (eg 3i 1992a, Hutchings 1987).

The survey supported the view that a sizeable element of buy-in managers possessed previous experience of business ownership. 28.1 percent of Chief Executives had previously owned a significant share of a company for which they worked and 16.7 percent of Number Two's (Table

TABLE 6.3: PREVIOUS EXPERIENCE OF OWNERSHIP OF SIGNIFICANT SHARE OF A COMPANY (Private MBI's)

	Chief Executive	"Number Two"
Owning at least a significant share		
• % of sample	28.1	16.7
(Sample size	57	42)
Participation in earlier buy-in		
• % of sample	3.7	7.5
(Sample size	54	40)
Participation in earlier buy-out		
• % of sample	11.5	10.3
(Sample size	52	39)
Participation in earlier unsuccessful buy-out attempt		
• % of sample	16.7	16.7
(Sample size	54	42)

6.3). Such characteristics appear to confirm more general new venture studies, eg the percentage of small business founders in Carland, Carland and Aby (1988) being marginally lower, 27 percent, although considerably more than the 15 percent in Turok and Richardson's (1991) West Lothian survey. 3i (1992a) confirm that a significant source of managers for buy-ins is the second time entrepreneur. Venture capitalists in screening the new proposal could be expected to find this track record in independent business attractive (Shaw 1988) while the Team Leaders themselves would be well aware of the problems involved in running a private company. As indicated above major sources of such Team Leaders could be expected to be managers who had completed buy-outs before or others who had attempted a buy-out, failed but who had impressed their potential

backers. This was confirmed in that 11.5 percent of Chief Executives had participated in an earlier buy-out, and a further 16.7 percent had tried unsuccessfully to complete a buy-out (Table 6.3). A small number of Chief Executives (3.7 percent) and a larger number of Number Two's (7.5 percent) were taking part in their second management buy-in.

6.5 Composition of the Team

Successful entrepreneurs search out people and form and build a team based on what the opportunities require. The lead entrepreneur will be supplemented by a Team which fills any major voids in marketing, technical aspects and finance. While there may be overlapping and sharing of responsibilities, team members need to complement, not duplicate, the lead entrepreneur's capabilities and those of other Team members (Timmons 1990). The size of the team is also clearly a matter where major differences may emerge in buy-in practice: some target companies are likely to be too small initially to be able to support a large team or even a relatively small non-operating team (although expansion plans agreed at the time of buy-in may indicate that reserves of people should be carried) while others may be able to do so. However the flexibility of approach to management re-organisation may indicate that a small team which can be supplemented by others once the management problems of the target company have been properly identified could be preferable. Incumbent management have also to be properly assessed. Additionally consideration has to be made as to whether it is best to have a team who have worked together before or alternatively have been brought together because of their skills.

The survey indicated that teams when initially approaching financing institutions were reasonably small (Table 6.4) normally consisting of two people. By the time of the buy-in the average size had risen to 2.4 as attempts were made to reduce initial skills gaps. This was considerably less than in buy-out surveys, eg 4 in the earlier survey (Wright and Coyne 1985) or 5.5 in the later survey (Wright et al 1992) and between an average 3 or 4 in 1989/91 management in the majority buy-outs (3i 1992b); this is unlikely to be fully accounted for just by size differences between the deals

TABLE 6.4: COMPOSITION OF TEAM AND BOARD (Private MBI's)	Mean	Median	Standard Deviation	Sample Size
Number in buy-in team when orginally approaching financier	1.9	2	0.995	59
Final number in buy-in team at time of purchase	2.4	2	1.585	59
Number of existing senior managers taking voting equity	1.2	0	2.048	57
Number of other employees taking voting equity	0.6	0	3.973	57
Total number of directors	3.4	3	1.520	58
Number of non-executive directors	0.8	1	0.869	55

although this is important. Although, on average, at least one incumbent senior manager took voting equity, there was a median of zero implying that the extension of equity to existing managers may be more a feature of the larger private buy-in. The final board typically comprised three directors, which included the appointment of one non-executive director. This implies a higher degree of involvement of non-executives than in buy-outs. For instance in the 1983/85 CMBOR survey only 14.8 percent of the sample had a nominated Chairman and 40.1 percent nominated non-executive directors while 35 % of the 3i sample of management in the majority buy-outs had agreed on a non-Executive director from the outset (3i 1992b). Given the importance of monitoring to ensure performance gains, these percentages may be seen as low.

A relatively small size of team may result in there being significant skills gaps (Timmons 1990, Chatterjee 1988). Should there not be incumbent management with suitable abilities and skills, additional new management may need to be recruited to fill any gaps shortly after buy-in or be covered in another way until the size and profitability of the company can justify the expense (Table 6.5). Virtually a third of buy-in Chief Executives recognised that there was a gap in the

financial expertise of the original team with there being other significant shortfalls in terms of production and marketing skills in about a third of the cases.

TABLE 6.5: PROFESSIONAL/SKILLS GAP IN THE ORGINAL BUY-IN TEAM (Private MBI's)	
	% of Sample
Finance	31.0
Marketing	19.0
Production	22.4
Other	8.6
(Sample size	58)

A key role for the institution in initial screening and early post-investment monitoring is in assessing when additions should be made to the team and whether they should be picked at an early stage by the team leader or later through a more general selection process. Other issues concern the method by which the team was picked and whether the members had worked together before or had some previous form of contact. Considerable dangers may be expected to exist where members of teams did not know each other well. The team's ability to work together and act cohesively as a team in the early stages after completion of a buy-in, when they may be in an unfriendly environment and subject to pressures which may be new to them, may be a necessary, but not sufficient reason, for the success of the buy-in.

In this context 86.4 percent of a base sample of 44 responding to this question declared that they had actually known each other before (Table 6.6). Of those that had and responded to a sub-question (a base sample of 37) over three quarters had worked in the same organisation, almost half had known each other through professional contact and a third through social contact.

TABLE 6.6: TEAMS PREVIOUS CONNECTIONS (Private MBI's)	
	% of Sample
Teams who had known each other before	86.4
(Base for sample	44)
Type of previous contact	
• Had worked in same organisation	75.7
• Professional contact	45.9
• Social contact	32.4
(Base for sample	37)

6.6 Conclusions

This Chapter has analyzed the background characteristics of the Buy-in Team and supported various propositions raised in Chapter 4. In particular:

(a) Teams were smaller than in buy-outs with Team Leaders tending to have generally well rounded General Management backgrounds with Number Two's adding specialist skills but the small number in the Team resulting in initial skills gaps. Management Teams had known each other before (P1);

(b) Many Team Leaders were attempting the buy-in as part of a mid career change in what had been a relatively stable employment record (P2)

(c) A minority of Team Leaders were involved in at least their second major entrepreneurial experience of business ownership or had tried to arrange a management buy-out which had not been completed (P3);

(d) Team Leaders were typically well qualified in terms of professional qualifications and university education (P5); and

(e) A significant minority of Team Leaders had parents who were small business owners (P6).

CHAPTER 7

MOTIVATION FOR THE BUY-IN

7.1 Introduction

Motivation to carry out a buy-in may derive from a combination of factors including a Team Leader's need to achieve, life aims, position within existing firm, fears for redundancy and financial considerations. His desire to realise a perceived opportunity, develop his own strategy and build a successful organisation may make him appear relatively pro-active compared to buy-out Team Leaders with 'Push' factors unimportant (Chapter 3.2 (d)). At the same time for the transaction to actually take place the vendor of the business will be motivated by considerations such as prospects for the company, poor profitability, change in direction of core activities or in the case of privately owned companies succession problems (Chapter 2.2.4).

This Chapter tests specific hypotheses concerning both Team Leader (7.2) and vendor motivation (7.3) outlined in Chapter 3. These concern the degree to which buy-in managers may be considered to be more proactive than buy-out managers, the lack of influence of push factors in buy-ins, the effect of the degree of personal financial risk on pecuniary motivations and the relationship between the vendor's view of the prospects for the company and his motivation to sell the business

7.2 Managerial Motivation for a Buy-in

While managers who buy-in may be expected to have been relatively successful in previous careers and to be seeking this type of transaction for positive reasons rather than being pushed through the threat of (or actual) redundancy (Shaw 1987, Hutchings 1987), entrepreneurs are in particular seen to be motivated by a need for achievement (McClelland 1961). In contrast many buy-outs have been for defensive reasons especially in times of recession (eg Wright, Thompson, Chiplin,

Robbie 1991, Bleackley and Hay 1992). There may however be considerable dissatisfaction with aspects of the previous employment which encourage the manager to seek a move elsewhere and acts as a catalyst in the process towards business ownership (Shapero 1975, Boswell 1972, Brockhaus and Horwitz 1986).

To determine the motivation behind buy-in managers, eleven factors identified as potentially important motivational elements were ranked by respondents on a scale one to five, one being considered very unimportant and five the most important.

TABLE 7.1: MAIN PERSONAL MOTIVATIONS FOR BUY-INS (Private MBI's)

	% of Sample					Mean	Median	Standard Deviation	Sample Size
	Very Important			Very Unimportant					
	5	4	3	2	1				
To do kind of work you wanted to	41.5	22.6	17.0	7.6	11.3	3.76	4.0	1.371	53
Frustrated by head office control	28.6	10.2	12.2	12.2	36.8	2.82	3.0	1.692	49
Lack of opportunity in existing company	31.9	8.5	12.8	14.9	31.9	2.94	3.0	1.686	47
Avoid working for others	44.2	23.1	9.6	7.7	15.4	3.73	4.0	1.483	52
Develop own strategy	65.5	20.0	10.9	0	3.6	4.44	5.0	0.958	55
Recognition of a specific commercial opportunity	35.2	35.2	14.8	11.1	3.7	3.87	4.0	1.133	54
Vehicle for future acquisitions programme	41.8	21.8	20.0	7.3	9.1	3.80	4.0	1.311	55
To build a successful organisation	60.7	30.3	3.6	0	5.4	4.41	5.0	0.987	56
Earn significantly more money	24.6	22.6	22.6	11.3	18.9	3.23	3.0	1.436	53
Personal capital gain	44.6	17.9	19.7	8.9	8.9	3.80	4.0	1.341	56
Made redundant	12.1	0	3.0	6.1	78.8	1.61	1.0	1.345	33

Allowing for the possibility that managers may not openly declare that they undertake a buy-in primarily for personal gain, the two most important factors (Table 7.1) were reported as the ability

to develop one's own strategy and to build a successful organisation, both having mean scores of over 4.40. The highest 'five' rating was for development of own strategy with 65.5 percent of responses. Also highly rated was the recognition of a specific commercial opportunity.

Few managers appeared to be motivated by factors related to negative aspects of their previous employment. Redundancy which accounted for 12.1 percent of the sample was as expected lower than in most other surveys of new business ventures and compares with 21 % for purchasers of businesses in Cooper and Dunkelburg (1986). Other elements linked to previous employment-frustration with head office control and lack of opportunity with the existing company- were the lowest rated of the factors suggested. Somewhat surprisingly avoiding working for others which would to a large extent symbolise the transition from being an employee to being a business owner came only seventh in the ranking, reflecting the relatively stable employment background of the Team Leaders (6.3).

Pecuniary aspects in the form of both personal capital gain and the ability to earn significantly more money were surprisingly lowly rated; the emphasis on long term capital gain being shown in the difference in their individual rankings. While it may be difficult to obtain unbiased answers to questions on personal pecuniary influences, the responses do confirm statements made by some venture capitalists in subsequent interviews that buy-in managers frequently develop grand designs for the future of their business to satisfy their business and strategic ambitions which may not necessarily converge with the financial aims of the venture capitalist. The accumulation of wealth may best be seen as the means to the greatly desired independence and freedom from control from others (Ronen 1980).

These findings have some similarities to buy-out survey results despite their different character. In response to seven major factors respondents to the CMBOR survey of 1983-85 buy-outs (Wright, Thompson, Robbie 1992) ranked desire to control one's business as the most important

followed by long term faith in the company, the latter being interpretable as a defensive motivation. As in the buy-in survey, purely push factors such as fear of redundancy and fear of new owner had low ratings. Lack of head office restraints and the opportunity to develop one's own talents were close to the mid-point of the scale. Buy-out managers as well were motivated by the prospect of better financial rewards but again this was an above average but not a predominant factor.

A major motivational difference arises from management in buy-ins taking the initiative in pursuing a buy-in strategy. In 67.4 percent of the buy-out cases, the initiative for buy-out was taken by the management alone and with outside initiators being observed in only 5.7 percent of the sample (Wright, Thompson, Robbie 1992). The importance of management initiatives in the UK appears to be substantially above levels recorded in the U.S. for similar transactions, eg 42 percent in Taylor and Hooper (1989).

7.3 The Vendor's Motivation for Selling

While the management team may have been successful in identifying a target, its owner may not always be a willing vendor. Where there is a willing seller, the reasons why he is prepared to sell are important and need to be taken into account by the management team to ensure that the terms of the deal are attractive to the vendor. Chapter 2.2.3 has described the sources from which a private buy-in may come- a privately owned company, a quoted group, an overseas group, the public sector and receivership of a company or group. Reasons for sale which apply to both buy-outs and buy-ins have been seen as family succession in the case of privately owned companies (eg Birley and Westhead 1990) and for groups redefinition of core activities and financial distress (Bleackley and Hay 1992).

Respondents were asked to rank seven key factors likely to be behind the previous owner's wish to sell on a scale from 1 (very unimportant) to 5 (very important). A score of 0 was assigned if

TABLE 7.2: REASONS WHY PREVIOUS OWNERS' WISHED TO SELL (Private MBI's)										
	% of Sample						Mean	Median	Standard Deviation	Sample Size
	Very Important				Very Unimportant					
	5	4	3	2	1	n/a+				
Poor growth prospects of company	12.5	14.6	29.2	6.2	16.7	20.8	2.38	3.0	1.709	48
Lack of profitability of company	26.0	8.0	16.0	14.0	14.0	22.0	2.52	2.5	1.909	50
Redefinition of group core activities	30.5	17.4	6.5	6.5	6.5	32.6	2.61	3.0	2.145	46
Parent needed to raise cash quickly	4.6	11.6	0	7.0	16.3	60.5	1.00	0.0	1.589	43
Vendor found "difficulty" controlling company	19.1	29.8	14.9	6.4	12.8	17.0	2.85	3.0	1.793	47
Vendor required finance for acquisitions	6.4	6.4	8.5	10.6	17.0	51.1	1.21	0.0	1.601	47
Retirement of owner	42.8	4.1	12.2	4.1	8.2	28.6	2.84	3.0	2.183	49

+ Not known to be relevant

the factor was not known to be relevant. The three most important were classic reasons for sale (Table 7.2) reflecting succession problems (for privately owned companies) and key control and core activity reasons for divestment by Groups (eg Green and Berry 1991).

Reflecting the dominance of family owned firms as sources of buy-ins, 42.8 percent of the sample stated that the retirement of the owner was very important. In almost a half of the cases (48.9 percent) vendor 'difficulty' in controlling the company was scored at 4 or 5. In almost as many cases (47.9 percent) a re-definition of core activities, both key factors behind plc or overseas owned companies seeking to divest subsidiaries, was seen as of above average importance.

Lack of profitability of the company was seen as the next most important factor (compare below, 8.4, with the Team Leader's relatively high ranking of seeking a company with a turnround factor) with poor growth prospects of the company fifth. Cash requirements of the vendor were considered unimportant; 60.5 percent of respondents reported that a need for the parent to raise cash quickly was not relevant and over a half (51.1 percent) that a vendor requirement for finance to make acquisitions was also not relevant.

Respondents were also asked to state any other factors as reasons for sale. These included family pressures in privately owned companies and disagreements with partners. Another relatively common reason concerned franchise policy. A significant number of buy-ins have taken place within the motor distribution industry. The motor manufacturer's dealer agreement gives considerable power to replace under performing franchisees by managers from elsewhere in their network whom they believe would make good dealer principals (Menzies and Welton 1991).

As is to be expected given buy-outs and buy-ins in their roles as alternative methods of corporate restructuring, the main reasons for sale appear to closely parallel vendor motivations for sale through buy-out. Respondents to the 1983-83 survey of buy-outs (Wright, Thompson, Robbie 1992) gave the most important reasons for sale of the company as strategic restructuring, poor profits prospects and retirement of the main shareholder in a privately owned company. 39 percent of respondents named strategic restructuring as the vendor's most important motive, followed by poor profits (17.0 percent) and retirement (9.9 percent).

Respondents to the buy-in survey were also asked why the previous owner was prepared to sell to a management buy-in team. Responses were then classified and the most important factors (Table 7.3) seen to be to provide continuity of the business and employment and, related to this, prospects with the right owner. The third most important factor was that the team leader was personally known to the vendor. Other major reasons were the price the buy-in team were

TABLE 7.3: REASONS FOR SELLING TO A MANAGEMENT BUY-IN TEAM (Private MBI's)	%
Continuity of employment/business	22.0
Prospects with right owner	20.0
Personally known to vendor	14.0
Price	12.0
Timing/speed	10.0
Franchise agreement	6.0
Confidentiality	6.0
Other	34.0
(Base for sample	50)

prepared to offer, the timing or speed of the transaction, franchise implications and confidentiality factors. Vendor tax implications, no suitable incumbent management to make a management buy-out feasible, institutional pressure for a sale and no other offer on the table were also mentioned.

7.4 Conclusions

This Chapter has reviewed the results of the statistical analysis of the buy-in questionnaire in the area of motivation of both the Team Leader and the vendor. It has confirmed part of Proposition P7 that buy-in motivation is little influenced by 'push' factors with Team Leaders seeking to develop personal long term goals rather than showing dissatisfaction with their previous employment. It has also provided some initial support to the rest of Proposition 7 that Management Buy-in Team Leaders are more pro-active than MBO Chief Executives and have a relatively high Need for Achievement. As in McClelland's characterisation of individuals with high nAch scores (see eg Brockhaus and Horwitz 1986) buy-in Team Leaders clearly show among other influences a high preference for personal responsibilty for decisions (the high scores for developing own strategy, avoiding working for others and building a successful organisation).

However, contrary to Proposition P8, pecuniary influences do not appear to be particularly high in the Team Leader's motivation despite the considerable personal financial risk factors involved.

There is support for Proposition P10 that the vendor's motivation to sell the business is strongly related to change in core activities and in the case of private vendors succession issues with poor profitability being important in both private sales and divestments. As noted in Chapter 5, there are significant differences between the source distribution of management buy-outs and buy-ins.

This Chapter has examined on a univariate analysis basis motivational aspects of buy-ins and compared them with buy-outs. Chapter 12 will later develop these motivational factors to identify typologies of buy-in and buy-out Team Leaders and assesses differences between the two.

CHAPTER 8

IDENTIFICATION OF THE TARGET, THE ROLE OF NETWORKS AND TYPES OF INCUBATORS

8.1 Introduction

Though a large number of managers express a desire to effect a management buy-in and may find an institution willing in principle to back them, the buy-in cannot proceed without an appropriate target company. In successfully identifying the target company, issues arise which are quite different to buy-outs where the target is always in place even if the venture capitalist's financial projections show that the proposed transaction is not viable. The process of search to find a suitable target can take a considerable period of time and may be complicated by team members continuing existing employment. Issues are raised concerning the way in which the target search is initiated, incubator organisations, the role of formal and informal networks in the process, the type of target sought and the methods used to find it.

This Chapter tests propositions outlined in Chapter 4 concerning the period taken to complete a buy-in including failed attempts for other targets, the use of informal rather than formal networks and the type of research methods used, the characteristics of the companies being sought and the role of institutions and the contribution of professional advisers in the search process.

It examines:

(a) The Buy-in process (8.2);

(b) The role of networks (8.3); and

(c) The characteristics of the Target Company (8.4).

8.2 The Buy-in Process

In a buy-in the target may not necessarily be immediately apparent and key factors which might make it attractive (or vice versa) for the purchaser may be difficult to discover. The Team have to go through a necessary search and analysis process. Additionally many contemplating a buy-in may have little personal experience of the process of company acquisition or of raising equity and loan funds for a company.

TABLE 8.1: PERIOD OF SEARCH FOR A TARGET COMPANY (Private MBI's)	
	% of Sample
Less than 6 months	50.0
6-12 months	22.4
1-2 years	13.8
2-3 years	5.2
More than 3 years	8.6
(Sample size	58)

As a result the total time required to initiate, progress and complete a buy-in can be expected to be significantly longer than a buy-out and more like that of a new venture project. Half the sample of private buy-ins took longer than six months to identify the target company (Table 8.1) and a quarter longer than one year. This compares with a minimum of three months from a buy-out Team's initial contact with an adviser, or four to five months for a larger transaction (Wright, Normand, Robbie 1990).

TABLE 8.2: BIDDING COMPETITION (Private MBI's)		
	%	Sample Size
Other serious bidders	56.9	58
• Of which buy-out team	16.1	31

The identification of a target company which is for sale and acceptable to management and their financiers may in itself not lead to completion of a buy-in. In 56.9 percent of the cases (Table 8.2) other serious bidders were present, of which 16.1 percent were management buy-out teams.

TABLE 8.3: BIDS MADE FOR OTHER COMPANIES
(Private MBI's)

	% of Sample
Bids made for other companies	31.0
(Sample size	58)
Number of unsuccessful bids	
• Mean	1.7
• Median	1.0
• Standard Deviation	1.337
(Sample size	10)
Reasons for unsuccessful bids	
• Offer price bettered by trade buyer	47.1
• Offer price bettered by MBO team	0
• Vendor decided not to sell	35.3
• MBI team withdrew offer	0
• Other	17.6
(Sample size	17)

Most buy-in teams were successful with their first bid. However, almost one third of buy-in teams had formally made bids for one or more other companies (Table 8.3). Where previous bids had been unsuccessful, the major reasons were due to their offer price being bettered by a trade buyer in almost half the cases whilst in over a third of cases the vendor decided not to sell.

The above highlights the problems which can be encountered in buy-ins or any form of corporate acquisition negotiations. To discover any particular problems which might relate to buy-ins, respondents to the survey were asked to state major difficulties which they had experienced during the negotiations. Some thirty seven companies (62.7 percent of the total sample) reported one

or more major difficulty. There was considerable variety in the type of difficulty identified, with no one problem being especially outstanding (Table 8.4).

TABLE 8.4: MAJOR DIFFICULTIES SPECIFIED BY MANAGEMENT AND ENCOUNTERED DURING NEGOTIATIONS (Private MBI's)

	Number of Companies Specifying Problems
Target co information	5
Fund raising	2
Valuation	3
Institutional time wasting	2
Vendor change of mind	2
Adviser miscalculations	2
Price; final terms; structure	6
Paperwork; too many advisers	6
Bank security	3
Tax; Inland Revenue	1
Warranties	1
Change of Advisers	2
Speed	4
Other	12
Total companies specifying difficulties	37

The most important difficulties related to pricing, final terms, and structuring of the deal; the paperwork generated and the number of advisers; and inadequate information on the target company.

In some cases management reported problems in getting the vendor to either make a decision on the terms of the proposed deal or alternatively seeking to change what had already been agreed. A creative and flexible approach to the deal making was required and in some cases, especially when buying from a private source, the way the deal was structured was particularly important.

Excessive paperwork generated by the transaction, a common problem relating to buy-out and buy-in transactions, was reported. Some appeared to query the need for so many advisers (and their fees) and to whether this led to virtual self generation of paperwork which disrupted the managers' time. The third most important point, the lack of information which was available on the target, was stressed by managers during subsequent case study interviews. None of the managers interviewed in the private buy-in case studies (Chapter 14) felt that they had been able to accurately gauge certain individual problems of the firm which were subsequently to dominate their initial efforts to attain planned projections. Types of problem could range from the datedness of audited accounts with management accounts not being made available, to efforts to restrain the new management from carrying out due diligence procedures such as contacting customers or suppliers. The ability of accounting advisers to identify such problem areas is crucial with one of the case companies (The Maids) taking legal action against the company's previous auditors (Appendix A7) and European Brands against their accounting adviser (Appendix A11).

Another area which caused concern was the speed at which the transaction proceeded. This problem, usually vendor but sometimes adviser related, exacerbating problems of accounting information not being up to date and could be associated with possibilities of the business being allowed to decline once the vendor was reasonably satisfied that there was a committed buyer. Fixed asset and stock valuation also gave concern.

One of the key decisions in the buy-in process is when the team leader should leave his employment. The median in the survey was 3 months before buy-in completion with an average of six months (Table 8.5). Given that half the searches took over six months, many managers actively searching for a company were still working for their existing employer. This both raises serious legal issues and may indicate important personal problems as individuals try to commit themselves to their present employer as well as trying to find time to do the necessary research to identify appropriate target companies. Confidentiality factors in doing this can be critical.

TABLE 8.5: THE PERSONAL SEARCH FOR A TARGET COMPANY (Private MBI's)	
Period between leaving employment and mbi completion	
• Mean (months)	6.0
• Median (months)	3.0
• Standard Deviation	9.13
(Sample size	54)
Consultancy set up between employment and mbi	
• Yes (%)	25.0
• No (%)	75.0
(Sample size	56)
Financial help offered by financing institution	
• Yes (%)	3.9
• No (%)	96.1
(Sample size	51)

Employers who discover that an employee is conducting such a search may take a harsh view. However if the employee leaves his present employment at an early stage, he may find himself without any income for a long period. Some institutions may provide forms of research and secretarial support to speed the search, but in only two cases in our sample was institutional financial help in this period made available. An alternative possibility (used by a quarter of the sample) is to leave one's present employment and establish a consultancy. The income generated may help to offset costs and perhaps create useful tax losses.

8.3 The Role of Networks in Target Identification and Deal Completion

The ability of the Team to draw upon the knowledge and skills learnt in their incubator employment and apply them in a new environment is likely to be a key factor governing the search for a target company. As described in Chapter 2.4.3, there is a close relationship in activity between previous employment and the new enterprise. Likewise with buy-ins, both managers and the backing institutions are likely to feel happier in looking for target firms which have similar

characteristics or associations with previous employment (De Quervain 1989). Well rounded management experience in non-technical sectors may however result in these circumstances in less compelling reasons to seek such similarities. The availability of key members of the team actually to carry out the appropriate research, negotiate and purchase what may be competing companies in the same sector may however depend on the previous employer: managers may have service contracts, for instance, which expressly forbid them to take equity or even work for companies which could be seen as being competitors.

Just over a quarter of Chief Executives had in fact changed industrial sector showing this wider approach to the problem of target search and the institution being prepared to accept that they were backing the ability of the manager to apply his skills in a more general context. For Number Two's the proportion of those changing sectors was lower (14.3 percent). Research into sector changes in US new ventures show more entrepreneurs changing sectors, typically a small majority (50-55 %) staying in the same sector for manufacturing and service companies (Cooper 1970, Hoad and Rosko 1964 and Mayer and Goldstein 1965). Cooper and Dunkelburg (1986) noted that 59 % of managers purchasing business had the same or similar customers and 62% had products or services which were the same or similar.

A major problem in the development of management buy-ins may be the ability to match significant numbers of highly competent managers wishing to complete a deal with appropriate target companies. The balance of applications to join the 3i management buy-in programme to the actual number of investments made highlights the problem (3i, 1992a). The method by which targets have been identified and the way a deal has been initiated are therefore crucial to the process.

Deals may be initiated in various ways: by the management team approaching an institution in relation to a specific project; by a general approach by the management team to an institution;

by an approach by management to an intermediary such as a company broker; the use of newspaper Business for Sale columns; by the employment of accountants or management consultants to search out a suitable target; and by the identification of a target by an institution which attempts to find appropriate management, eg the approach taken by US LBO partnerships.

TABLE 8.6: SOURCE OF INITIATION OF BUY-IN (Private MBI's)	% of Sample
Own general approach to a financing institution	56.9
A specific company proposal made to a financing institution	43.1
An institutional approach for an existing project	1.7
An institutional approach for a potential project	5.2
'Head hunters' acting for an institution	0
Other	3.5
(Sample size	58)

The survey indicates that institutions themselves play only a minor role in initiating the buy-in process (Table 8.6); only 6.9 percent of respondents stated that an institution had approached them for either an existing or potential project. In over half of cases the buy-in had been initiated by management's own general approach to a financing institution which would then be followed by more detailed target identification and help from the institution. Over two fifths (43.1 percent) of management however made a specific company proposal to the institution.

Methods of identification of the target can be expected to involve the use of both formal and informal networks. Research on new venture creation generally suggests that informal networks play a key role in the founding of new ventures (Birley et al 1991) although experienced managers could be expected to use the formal networks more extensively given the development of links with professional advisers as their careers progressed. Despite the latter influence, management's

own knowledge and effort emerged clearly as the most important method for identifying the target company (Table 8.7).

TABLE 8.7: IDENTIFICATION OF TARGET COMPANY (Private MBI's)	% of Sample
Buy-in team's industry knowledge	67.2
Suggestion by your financial institution	17.2
Suggestion by your accountants	5.2
Suggestion by your bankers	1.7
Suggestion by personal contact/friends	19.0
Suggestion by customer/suppliers in your previous employment	1.7
Personal Research	41.4
Other	8.6
(Sample size	58)

In over two thirds (67.2 percent) of cases the target had been originally identified through the team's industry knowledge. Almost a fifth (19 percent) had been identified through the use of friends and or personal contacts. The team's own research was seen also as being very important, 41.4 percent of targets having been identified in this way.

The use of own and informal networks was thus high: the target was suggested by the institution in only 17.2 percent of cases despite the institution's latter role in the transaction. It was unusual to use other intermediaries such as accountants, who might have been expected to be in a good position to help identify targets. In only one case had bankers identified a target.

As well as their possible role in the identification of targets, the formal network as represented by accounting and legal advisers and financiers will have a crucial role in completing the deal process. Others may be involved to provide more specialist advice- for instance on behalf of the

financing institutions as a reporting accountant, special consultants to check industrial market projections and additional solicitors. The Team may employ other specialist advisers on corporate and personal taxation matters, property, plant and equipment valuation, insurance and pensions. In some cases there will be overlapping of interests between management and institutional advisers (Wright, Normand, Robbie 1990). Houlden (1990) points out the need to distinguish between good and bad advisers.

TABLE 8.8: PERFORMANCE OF PROFESSIONAL ADVISERS (Private MBI's)

	% of Sample					Mean	Median	Standard Deviation	Sample Size
	Very Satisfied				Very Dissatisfied				
	5	4	3	2	1				
Accounting Advisers	36.8	21.0	28.1	8.8	5.3	3.75	4	1.199	57
Legal Advisers	49.1	28.8	8.5	8.5	5.1	4.09	4	1.179	59
Financiers	46.6	34.5	17.2	0	1.7	4.24	4	0.865	58

Respondents were asked to score the performance of three main types of advisers on a scale from one (very dissatisfied) to five (very satisfied). All three sets of advisers were rated on a median of four on this basis (Table 8.8). The mean score for accounting advisers was below the other two with just over half (57.8 percent) claiming that they were more than averagely satisfied with their performance. The best result, that of financiers, showed only one respondent actually dissatisfied with their performance while 81.5 percent were more than averagely satisfied.

Respondents were then asked to state any areas of their advisers' performance with which they had been expressly impressed or dissatisfied. The responses were then categorised as shown in Table 8.9).

TABLE 8.9: SPECIFIED ASPECTS OF PROFESSIONAL SERVICES
(Private MBI's)

By Number of Cases

	Accounting Adviser		Legal Adviser		Financier	
	Impressed	Dissatisfied	Impressed	Dissatisfied	Impressed	Dissatisfied
Professionalism; quality of advice	10	7	8	-	6	1
Accuracy; tech competence; depth	3	7	9	4	1	-
Understanding; flexibility	-	1	3	1	4	1
Commitment	3	1	2	-	3	-
Speed; efficiency	2	1	6	3	7	2
Experience	-	1	1	-	3	-
Personal relationship	2	-	1	-	4	-
Expense	-	3	-	4	-	2
Price; terms changes	-	-	-	-	-	2
Other	2	2	-	2	1	2
Total	22	16	30	14	29	9

Respondents were most impressed by the following aspects of advisers' services. Accountants impressed most in respect of their professionalism and quality of advice (but little else); legal advisers in respect of their accuracy and technical competence, with their professionalism and speed and efficiency also scoring highly; and financiers for their speed and efficiency as well as their professionalism, quality of advice, understanding and flexibility, and personal relationships.

Although many respondents had been impressed by accountants' professionalism this was also the area in which others were most dissatisfied, together with accuracy and technical competence. Respondents were less dissatisfied with aspects of the other advisers' services, with only lawyers' expense, accuracy and speed being particularly notable. No respondents said that they were impressed by the experience or cheapness of any of the advisers. The case study interviews also produced many adverse comments about excessive fees by legal and accounting advisers (particularly for services by other departments in the firm in respect of accountants). The responses in general seem to be consistent with Taylor and Hooper (1989) who saw 72.8 percent of advisers being helpful. Their buy-out Team Leaders appreciated advisers' financial help, strategic input, involvement and advice and counsel.

A further indication of the strength of the respondents' concern about the performance of advisers is given by the extent to which advisers were retained after the buy-in was completed. This point is most relevant for accountants and lawyers as financiers are effectively locked in until the structure can be changed in the medium term.

Almost a quarter of the sample (Table 8.10) had decided not to retain one of the advisers, the accounting adviser being the one most likely to be dropped.

TABLE 8.10: RETENTION OF PROFESSIONAL ADVISER FOR FUTURE WORK (Private MBI's)		
	% of Sample	Base for Sample
Adviser retained	76.5	51
Adviser not retained	23.5	51
Type of Adviser not retained		
• Accountant	50	10
• Legal Adviser	40	10
• None	10	10

The importance of the incubator organisation and the role of networks can be seen also in the team's preference to stay within the same industrial sector and an analysis of the existing knowledge they had about the target company.

TABLE 8.11: SPECIAL KNOWLEDGE OF TARGET COMPANY (Private MBI's)	
	% of Sample
Those with special knowledge	59.3
(Sample size	59)
Of which -	
• Professional contact	54.3
• Earlier employment	22.9
• Relationship with previous company	37.1
• Competitor	34.3
• Supplier	11.4
• Other contact	14.2
(Sample size	35)

The majority (59.3 percent) of the sample had a special knowledge of the target company (Table 8.11). Of those teams which had a special knowledge of the target, over half had this from professional contact. The target was three times more likely to have been a competitor rather

than supplier in a previous job. Over one third had a relationship with the team leader's previous company while some had been in earlier employment (though more likely on a group or sister subsidiary basis).

Such special knowledge can be useful in decreasing the risk factors involved in a buy-in: it may allow a closer look at the position of the target in the market and permit a more thorough analysis of the target's strengths and weaknesses. These reasons clearly also have implications for the search for suitable targets: teams are going to have more success in identifying companies where private owners are nearing retirement or in looking for subsidiaries of a plc where the parent is changing direction and a potential target does not fit nicely into the group.

Another aspect of the ways in which the target company was identified is through an examination of the research method used by the buy-in manager. Given their considerable management experience much of it gained in large companies, it could be expected that relatively sophisticated research methods would be used to help identify the target and provide essential background information prior to the more detailed due diligence work which would be necessary at the later stage.

Responses to the types of research methods used (Table 8.12) showed that while a wide variety of research methods for company identification were used, they were not as extensive nor as sophisticated as could have been expected. The most common research method for helping to identify targets was through the use of newspaper/media reports/searches, just over a quarter of the sample using this method. Some use of trade directory and reference books was made (19.3 percent) and others made use of trade associations (12.3 percent). Relatively little use was made of more advanced research methods such as 'On-line' company data searches (also 12.3 percent). Few managers used courses, seminars or conferences to find out about the buy-in process. Despite

TABLE 8.12: TYPES OF RESEARCH METHOD (Private MBI's)	
	% of Sample
Specialist courses/seminars/conferences	3.5
The 3i MBI programme	7.0
'On Line' company data searches	12.3
Trade directories/reference books	19.3
Newspaper/media reports/searches	26.3
Trade Associations	12.3
Government programmes	7.0
Specialist consultant/company broker	10.5
Other	5.3
(Sample size	57)

the large number of buy-ins financed by 3i in the sample, only 7 percent had been on the 3i management buy-in programme, the most publicised programme for potential buy-in managers.

8.4 Characteristics of the Target Company

There is inevitably a wide range of company attributes and industrial sector characteristics which guide managers' search processes. Team leaders were asked to score the importance of ten different search criteria on a scale of 1 to 5, 1 being the least important and 5 the most important.

The most important considerations (Table 8.13) were the industry (60 percent ranking this the most important), potential market growth and turnround potential. The last underlines the notion that target companies are being sold because of their under-performance with incumbent management unable to perform the necessary turnaround. Customer base was also important. Incoming management therefore could be seen to believe that they were buying into companies which were probably under-performing in a sector which they knew. In contrast the shell potential of a target, ie buying a company which has few assets but could act as a medium for rapid

expansion, was seen as the least important factor. The actual size of the company in terms of turnover was not so important underlining the preparedness of managers to accept a

TABLE 8.13: IMPORTANCE OF CRITERIA IN SEARCH FOR SUITABLE TARGET COMPANIES (Private MBI's)

	% of Sample					Mean	Median	Standard Deviation	Sample Size
	Very Important			Very Unimportant					
	5	4	3	2	1				
Location	23.6	20.0	23.6	7.3	25.5	3.09	3.0	1.506	55
Industry	60.0	10.9	18.2	3.6	7.3	4.13	5.0	1.263	55
Particular technology	11.8	7.8	37.2	11.8	31.4	2.57	3.0	1.330	51
Sales turnover	7.6	22.6	41.5	15.1	13.4	2.96	3.0	1.109	53
Potential market growth	48.2	41.1	7.1	3.6	0	4.34	4.0	0.769	56
Competitive strength	27.8	33.3	25.9	7.4	5.6	3.71	4.0	1.127	54
Customer base	29.6	33.3	29.7	3.7	3.7	3.82	4.0	1.029	54
Asset value	12.9	14.8	38.9	24.1	9.3	2.98	3.0	1.141	54
'Shell' potential	8.0	10.0	14.0	16.0	52.0	2.06	1.0	1.346	50
Turnround potential	46.3	24.0	9.3	3.7	16.7	3.80	4.0	1.484	54

target which could be significantly smaller than the company for which they were previously working. Despite new venture research findings that new businesses are founded close to the founder's home and previous employment (Chapter 2.4.3), the actual location for buy-in managers did not emerge as being so significant. A fifth of Team Leaders had moved house to another region and almost three tenths of Number Twos. The location of the company was seen as slightly more important than the size although less than a quarter of respondents rated it as very important. There was a large gap between this in terms of importance and the next highest rated aspect- the competitive strength of the company.

In analysing the future prospects for the target, characteristics of the overall industrial sector will be important in the decision making process for both the financing institutions and managers. Financing institutions are likely to be most interested in investment opportunities which conform to classic LBO characteristics such as predictability of demand and positive cash flow, low threats from new technology and import competition and where a rapidly growing industry is not going to cause high development expenses or result in sharp increases in working capital (eg Easterwood et al 1989). Their risk and financing instrument redemption/repayment will be best served through a more conservative application of these factors given their less detailed knowledge of the company.

TABLE 8.14: PERCEPTION OF CHARACTERISTICS OF INDUSTRIAL SECTOR (Private MBI's)

	% of Sample									
	5	4	3	2	1		Mean	Median	Standard Deviation	Sample Size
Very Stable demand	30.4	42.8	26.8	0	0	Very unstable demand	4.04	4.0	0.762	56
Industry size declining	5.3	21.4	30.4	30.4	12.5	Rapidly growing industry	2.77	3.0	1.095	56
Very stable technology	26.9	28.8	36.5	3.9	3.9	Very unstable technology	3.71	4.0	1.035	52
Low exposure to import competition	27.8	31.5	24.1	11.1	5.5	High exposure to import competition	3.65	4.0	1.168	54
Highly cash flow positive	21.4	21.4	26.8	19.7	10.7	Significant cash requirements	3.23	3.0	1.293	56

Managers were asked to rank various factors concerning their perception of the underlying characteristics of the target company's industry (Table 8.14). Industries were clearly perceived to have a very stable level of demand as the main characteristic, none of the respondents noting anything more unstable than a middle ranking. Relative stability was seen in terms of technology and low exposure to import competition. Only 7.8 percent felt that their industry technology was unstable and 16.6 percent that there was an above average exposure to import competition.

Malone (1989) in asking similar questions of smaller US LBOs (those less than $50 mn) also noted stability of demand and low exposure to foreign competition.

While such results are also similar to what could be expected for buy-outs (eg Seth and Easterwood 1992), two other factors do imply some difference. First 42.5 percent of the sample felt that the industry was rapidly growing (even if demand was stable). Secondly cash flow characteristics were surprisingly not as positive as could have been expected although to some extent this may have been influenced by the plans of some managers to expand rapidly through acquisitions. 30.4 percent of the sample indicated significant cash requirements as opposed to neutral or positive cash flow characteristics. These two factors do suggest a variation from the normal buy-out concept.

8.5 Conclusions

This Chapter has examined the methods by which targets have been identified, the role of networks and the relationship with previous incubators. While formal networks have been used to ensure the buy-in proposal moves to completion, the key area of target identification appears to lie with informal contacts and especially with the personal (and frequently existing) knowledge of the Team Leader. Indeed search methods used appeared surprisingly unsophisticated, as these informal methods were employed. In almost three quarters of cases this was facilitated by the target company being in the same sector as that of the Team Leader's immediately previous employment. The subsequent use of formal networks involving accountants, legal and advisers and providers of venture capital appears to work satisfactorily, with the majority of Team Leaders referring positively to the level of service provided despite concerns over the costs involved. The type of company sought only conformed partially to the typical buy-out norm- involving stability in terms of both market and technology with cash flow and overall industry size characteristics implying a more growth orientated strategy than seen in US LBO studies.

In particular support was found for the following propositions:

(a) The period required to complete a buy-in was significantly longer than in buy-outs and frequently involved failed attempts for other targets (P13);

(b) With the target company likely to be in the same sector as the Team Leader's existing company, personal knowledge and the use of informal rather than formal networks were more important elements in target identification than more sophisticated methods of company search (P14);

(c) Unlike many U.S. LBOs The Team were expected by institutions to identify the target (P15);

(d) Company characteristics differed from those of buy-outs having potentially significant cash flow requirements, being in a less mature but more growth orientated sector and involving products where there is a higher technology risk (P11);

(e) A major motivation for purchase of a particular target was the possibility for achieving a turnaround; and

(f) Unlike buy-outs a minority of buy-ins involved Team relocation to another region (P4).

CHAPTER 9

FINANCIAL STRUCTURING AND EQUITY OWNERSHIP

9.1 Introduction

As described in Chapter 2.2 the benefits of corporate restructuring are partially derived from the use of more highly leveraged financial structuring and the incentives of equity ownership for managers. In the case of management buy-ins the higher risk factors (eg lack of insider knowledge of the company, the problems inherent in the use of external management) may result in structures being more conservatively geared than in buy-outs; venture capitalists will still expect some of the performance benefits to be derived from the bonding effect of debt although some structures may need to reflect a 'war chest' for future acquisitions. Part of the incentive for management will come from the use of equity ratchets. The benefits to be derived from this form of corporate restructuring will also involve more direct monitoring and control by investors than in the conventional public corporation. While designed to enhance the prospects for the company, some Team Leaders may feel that this control is restrictive.

This Chapter tests hypotheses and propositions advanced in Chapter 4 concerning leverage ratios, the provision of incentives to management through the use of equity ratchets and Governance issues including the possibility of management finding monitoring and control devices imposed by venture capitalists too restrictive. It proceeds by examining:

(a) Financing Structures (9.2);

(b) The level of Equity held by Management and Employees (9.3); and

(c) Financial conditions and relationships with institutions (9.4).

9.2 Financing Structures

General discussion of Corporate Restructuring in Chapter 2 has indicated the importance of financial structuring in ensuring that the performance benefits are obtained. The use of high levels of leverage will create debt bonding condition effects which will increase efficiency and while equity incentives will also motivate managers to improve efficiency (eg Jensen (1986)). Although the same financing instruments as in a buy-out can be expected to be used, their relative proportions will reflect the difference in perceived risk, structuring variations between institutions and the possibility of a lower degree of leverage.

TABLE 9.1: FINANCING STRUCTURES OF MBI
(Private MBI's)

	Equity (%)	Mezzanine (%)	Senior Debt (%)	Other (%)	Average Size (£mn)
1986	31.5	0	66.4	2.1	4.35
1987	28.0	20.3	47.9	3.8	2.36
1988	45.1	5.1	42.8	7.0	2.15
1989	21.9	9.1	54.0	15.0	4.94
All years	28.5	8.6	52.3	10.6	3.48

Responses to financial structuring questions were cross checked against information contained in Companies House returns where possible. The overall financing structure of the buy-in sample (Table 9.1) revealed substantial variations between years. The buy-ins included in the survey which were completed in 1988 and 1989 appeared to have less highly geared financing structures than the buy-outs completed in the same years contained on the Centre's main database. The average equity in the buy-outs completed in 1988 and 1989 was 26.2 percent and 18.7 percent respectively, compared to 45.1 percent and 21.9 percent for buy-ins in the survey. As with buy-outs there was a clear trend towards higher degrees of leverage in the late 1980's. Leverage, compared to US rates (eg Marais, Schipper and Smith 1989, Kaplan 1989, Malone 1989) remained low.

Comparison with Companies House records for most of the companies confirmed that significant variations to these basic structures were principally among the smaller deals. These included management in some cases providing a major contribution to preference share capital and at times secured or subordinated debt. Although venture and development capital institutions traditionally subscribe only ordinary and preference share capital and leave debt instruments for clearing banks, there was a large number of cases where such institutions provided ordinary share capital and then substituted loans for what normally would have been a preference share capital subscription. The terms of such loans also showed significant variances- some for instance clearly having a marked degree of subordination and bordered on mezzanine debt while others were at terms and margins which would be quite close to those obtainable from clearing banks. Almost a third (32.2 percent) of survey respondents had loans which were provided by the equity leader and were classed as debt; a further 6.8 percent had facilities which were considered to be mezzanine after analysis. A major contribution to other finance in several cases arose in the motor trade sector where stocking plans financed by the motor manufacturers' credit company, eg Ford Motor Credit, were a key element in financing. A large number of buy-ins also made extensive use of leasing and hire purchase facilities.

9.3 Managerial and Employee Equity

An important issue concerns the use of managerial equity to give an incentive to perform and for institutions to be able to more closely monitor the performance of the company (Chapter 2.5). This may be achieved by some institutions through the setting of the initial percentage of equity on a fixed basis while others may use ratchets to provide a longer term incentive (or disincentive) if plans are not realised (Thompson and Wright 1991).

The structuring of the deals in general resulted in management obtaining a majority of the voting equity (Table 9.2) with a median equity share of 60 percent. Although in 23.2 percent of cases there was some vendor retention of shares, the actual effective level of this was extremely small

TABLE 9.2: EQUITY STRUCTURE (Private MBI's)	Mean	Median	Standard Deviation
Buy-in team (%)	54.0	60.0	22.545
Existing management/employees (%)	4.4	0	9.651
Institutions (%)	36.4	33.3	19.605
Vendor (%)	1.5	0	6.075
Other	3.7	0	17.321
Cost of buy-in team shares (£'000)	135	100	128.521

amounting overall to 1.5 percent. In a few cáses existing management were offered participation; this was low reflecting the exclusion of cases from the survey where a hybrid MBI/MBO took place. Managers provided a median level of finance of £100,000 for the transaction although the average was higher at £135,000. This is not too dissimilar from amounts in management buy-outs (see Table 5.12). 3i have noted in their survey of management in the majority buy-outs that the average team investment was between £100,000 and £150,000 excluding cases where individuals rolled over existing shareholdings; the actual cash invested per director averaged £40,000 with the range £20,000 to £120,000 (3i 1992b).

This also compares with the management buy-out survey where in 77.3 percent of cases the incumbent management team had at least half of the equity and in 16 percent of cases management held all the equity (Wright, Thompson, Robbie 1992). In the US even in smaller transactions management may not have a majority stake; for instance in one survey (Malone 1989) of LBOs with a transaction price of less than $50 mn, management held an equity stake of 50 percent or more in only 39.3 percent of transactions.

Management may use several means of raising their contribution of finance. Given the high element of housing in the composition of the personal wealth in the UK, it was not surprising that the main source was the re-mortgage of a house (Table 9.3), 58.9 percent of both Chief

TABLE 9.3: SOURCE OF PERSONAL FINANCE (Private MBI's)		
	% of Sample	
	Chief Executive	"Number Two"
Golden handshake from previous employer	16.1	13.9
Re-mortgage of house	58.9	58.3
Sale of other personal financial assets	17.9	8.3
Loans from friends/family	10.9	11.4
Other cash resources	26.8	13.9
Other	9.1	13.9
(Sample size	56	36)

Note: % may add to more than 100 because of multiple responses.

Executives and Number Two's using this as the main source. Golden handshakes from previous employers despite the relatively low incidence of redundancy among our sample was also a significant source. Chief Executives who probably would have had more opportunity for accumulating wealth engaged in a significant element of selling other personal financial assets. Loans from friends and family also emerged as a major source, being used over 10 percent of cases.

As described above ratchets can be used to increase or decrease management's share of the equity according to certain pre-set criteria. Almost two fifths of the sample had ratchets (Table 9.4) compared to 30 percent in the earlier CMBOR survey of 1983/85 buy-outs (Thompson and Wright 1991) and 8 percent of 3i management owned buy-outs (3i 1992b). The average size of the initial equity stake was much lower in cases with ratchets than for the overall sample, confirming that ratchets tended to apply to the larger deals. The minimum median equity stake in those deals with ratchets was 25 percent and the maximum was 51 percent. The ratchets operated over a median time of 3 years.

TABLE 9.4: EQUITY RATCHETS (Private MBI's)				
Buy-ins with ratchets (%)	39.0			
(Sample size	59)			
	Mean	**Median**	**Standard Deviation**	**Base for Sample**
Ratchet minimum (%)	30.52	25.0	19.378	19
Ratchet maximum (%)	48.21	51.0	15.696	19
Ratchet trigger period (years)	3.75	3.0	1.517	20

Ratchet Trigger Criteria	**% of those with ratchets**
Profits only	42.9
Capitalisation - on flotation or on sale to another company	14.3
Cash flow/redemption of financial instruments	14.3
Profits/capitalisation	23.8
Cash flow/capitalisation	4.8
Financiers internal rate of return	9.5
Other	9.5
(Base for sample	21)

The most important criterion triggering the ratchet mechanism was some profit related element (Table 9.4). 42.9 percent depended exclusively on profits over a set period with a further 23.8 percent being related to a mixture of profits and capitalization/valuation targets. Only 14.3 percent of ratchets were dependent on the capitalization of the company on flotation or sale to another company. Cash flow and financial instrument redemption factors were not extensively used.

A further aspect of the financing structuring is the level of incentive to existing employees including senior management through direct initial equity involvement or through the use of share option schemes. In only a few cases were existing management invited to take small levels of equity participation or new senior specialist management recruited following buy-in given equity

participation. The more general incentive effect however has been through earnings incentives which have been profits orientated.

TABLE 9.5: SHARE OPTION SCHEMES (Private MBI's)	
	% of Sample
Existence of share option scheme	15.5
(Sample size	58)
Applicable to	
• Only buy-in team	33.3
• Senior Management	66.7
• Employees	22.2
(Base for sample	9)
Intention to introduce a share option scheme	27.8
(Base for sample	18)

Only 15.5 percent of the sample (Table 9.5) had existing share option schemes which would be a major way of providing equity incentives to managers. Of those with option schemes two thirds were applicable to senior management but one third were restricted to the buy-in team only. There appeared to be little intention to introduce a scheme in the future: just five companies replied that they would be doing so. This contrasts with buy-outs where over a quarter of companies (26.9 percent) indicated an intention to introduce a scheme (Wright, Thompson, Robbie 1992).

None of the sample had an ESOP scheme in existence (Table 9.6). Nevertheless the possibility of introducing such a scheme in the future did elicit more encouraging replies than for the more conventional share option schemes- nine of the sample did report intentions to introduce such a scheme within a median period of two years.

TABLE 9.6: ESOP SCHEME (Private MBI's)	
	% of Sample
Existence of ESOP scheme	0
(Sample size	58)
Intention to introduce an ESOP scheme	34.6
(Base for sample	26)
Period to introduction of an ESOP Scheme	
• Mean (years)	2.89
• Median (years)	2
• Standard Deviation	2.088
(Base for sample	9)

9.4 Financing Conditions and Governance

Considerable stress was placed by managers on the selection of appropriate institutions and financing structures. Accounting advisers recommend teams should approach a selection of potential financiers. On average teams approached three institutions, the maximum recorded in the survey being seven. 27.6 percent of the sample, however, only approached one institution.

A key issue in both buy-outs and buy-ins is the control which equity and debt financiers have over the company: it is this direct control which can be expected to provide significant efficiency improvements (eg Jensen 1989). As part of the structuring of a buy-in, financiers will therefore introduce a variety of mechanisms to monitor the performance of the company to help ensure that the objectives of the existing parties are met (eg Lorenz 1989, Wright, Robbie et al 1992).

Respondents were asked to score eleven conditions commonly required by institutions in management buy-in transactions on a scale from five being 'very restrictive' to 1 being 'found to be useful' and 0 'not required'. Excluding inevitable aspects such as the financiers' equity stake,

type of financial structure advised and banking covenants, the most commonly used conditions were regular financial reports and restrictions on capital expenditure.

TABLE 9.7: CONDITIONS IMPOSED BY FINANCIERS (Private MBI's)										
	% of Sample						Mean	Median	Standard Deviation	Sample Size
	Very Restrictive			Found to be Useful		Not Req.				
	5	4	3	2	1	0				
Regular (monthly) financial reports	3.5	0	12.1	13.8	60.3	10.3	1.41	1.0	1.060	58
Board representation	0	1.7	5.3	12.3	29.8	50.9	0.77	0.0	0.982	57
Change of auditor "requirement"	0	0	3.5	7.0	12.3	77.2	0.37	0.0	0.771	57
Change of banker "requirement"	0	1.8	3.5	7.0	10.5	77.2	0.42	0.0	0.905	57
Restrictions on capital expenditure/ acquisitions/diversification etc	5.3	5.3	14.0	24.6	21.0	29.8	1.60	1.0	1.450	57
Purchase of other financial services "requirement"	3.6	3.6	5.4	8.9	7.1	71.4	0.73	0.0	1.368	56
Type of financial structure advised	5.3	12.3	10.5	14.0	26.3	31.6	1.61	1.0	1.578	57
Size of equity stake of financier(s)	5.3	17.5	15.8	7.5	31.6	12.3	2.11	2.0	1.472	57
Requirement not to approach other advisers/financiers after buy-in	1.8	3.6	9.1	3.6	7.3	74.6	0.66	0.0	1.294	55
Banking covenants	12.7	10.9	25.5	12.7	18.2	20.0	2.27	2.0	1.672	55
Personal guarantees	10.9	10.9	10.9	0	5.5	61.8	1.36	0.0	1.928	55

None of the restrictions suggested in the questionnaire was felt to be more than averagely restrictive (Table 9.7) although concerns seemed to be orientated towards the initial financial structuring of the buy-in rather than future institutional monitoring and control devices. There was also evidence that the controls imposed by banks were felt to be more restrictive than some demanded by equity providers. Banking covenants were emphasised as the most important

constraint, followed some way behind by the size of the institution's equity stake and the type of financing structure. Where personal guarantees were required these were generally found to be restrictive, probably because managers disliked giving them rather than a direct problem for the business, but the requirement only applied to less than two fifths of the sample.

Post buy-in monitoring of the company by institutions will effectively be carried out through a requirement for regular financial reports and representation on the board of directors. 90 percent of the companies in the survey required to submit financial reports on a monthly basis to their financing institutions. This was found to be the most frequently used and most useful condition. Managers during case study interviews also emphasised the benefits of being forced to provide regular financial reports. The requirement put pressure on managers to update antiquated internal reporting and accounting procedures and meant that more relevant information was available. The survey of buy-outs also noted that this was the most frequently imposed condition, with 80.2 percent of respondents being required to do this.

Representation on the board of directors was required in a half of the cases and was also found to be highly useful. While it may have been expected that the level of institutional board representation was low, it does reflect the low size of many of the buy-in companies: the cost of monitoring them in this way being high in relation to the original investment. It was clear in the case study interviews of companies where a non-executive director had not been appointed by the main financing institution, managers appreciated the significant benefits to be gained from maintaining close links with financial backers through regular informal meetings, both to win support for any future capital requirements but also to gain help should the business start to show signs of faltering. A more positive attitude from institutions was expected if they had been kept well informed. Those buy-ins with non-executive directors considered they were helpful and constructive as long as they had been carefully selected and could effect introductions to contacts who might be potential customers. Again the use of non-executive directors appears higher than

in the case of buy-outs, where 40.1 percent of respondents noted the institution's right to appoint non-executive directors. This is more in line with 3i, where about 35% of their management buy-outs had a non-executive director (3i 1992b).

In over three quarters of cases (77 percent) there was no requirement to change auditor or banker (Table 9.7). There was also no evidence of great pressure being applied to encourage management to purchase other types of financial services within a financing group, eg Keyman insurance policies through an insurance subsidiary.

9.5 Conclusions

This Chapter has analyzed financial structuring and equity arrangements in buy-ins and has in general found evidence that buy-ins are structured to reflect corporate restructuring equity incentive and control theory with the proviso that the degree of monitoring by equity providers through board membership is lower than might have been expected. In contrast control by the debt providers (through covenants and personal guarantees) was felt to be more restrictive. Equity incentives were particularly enhanced through the ratchet mechanism.

Specifically support is found for Management Buy-ins having lower leverage than buy-outs (part of Hypothesis H4). Additionally the following propositions can be confirmed:

(a) The need to provide incentives to management has led to extensive use of ratchets to enhance the Team's equity position (P16); and

(b) Venture capitalists appeared to monitor and control their investments in a "hands on" rather than "hands-off" manner, with greater intervention used than in management buy-outs (P24).

CHAPTER 10

MANAGEMENT ACTION POST BUY-IN

10.1 Introduction

Examination of Agency Cost Theory and the nature of Corporate Restructuring in Chapter 2 and their implications for performance of a buy-out company (Chapter 2.6.1) indicated that the period after a buy-out would be followed by significant actions to ensure that the company was run in a more efficient manner with particular efforts to introduce measures to improve operating profit and cash flow. Additionally the break in previous managerial systems caused by the appointment of a new Chief Executive and other senior management (as in a buy-in) may be expected to produce different actions of both strategic and operating natures than are usually observed in management buy-outs or new ventures (Chapter 3). The requirement for these changes will be increased when the company is in need of considerable turnaround (Chapter 2.6.3). Such actions will be important in ensuring achievement of the targets set by the venture capitalist and other financial backers when originally appraising the investment proposal (Chapter 2.4.4, 2.5.1). Chapters 6 and 8.3 have also confirmed that the majority of managers buying-in have had substantial general and specialist managerial experience in the same sector (and consequently should be well aware of the types of action which may be considered relevant within the sector) and are frequently looking for a target with considerable turnround and growth potential (Chapter 8.4).

The Chapter tests one hypothesis and four propositions cited in Chapter 3 and proceeds by examining the following:

(a) The overall extent and nature of actions taken by management (10.2);

(b) The extent and nature of administrative and financial actions (10.3);

(c) Product and Marketing actions (10.4); and

(d) Management and employment changes and incentive systems (10.5).

Additionally comparisons are made with other relevant surveys of management buy-outs; companies which have gone through 'sharpbender' and 'turnaround' phases; and new ventures to determine whether management buy-ins result in a particularly high level of restructuring activity (Chapter 10.6).

10.2 Overall Extent of Management Action

The changes which are required to strengthen the operation of the business may cover several general areas, the most important of which are likely to be management, administration and finance and product and marketing (see eg Chapter 2.6.3). Administration and finance may be sub-divided into pure administrative and secretarial matters, working capital finance and fixed asset finance. The changes which are implemented may relate to control systems as well as direct one-off forms of action.

The skills brought by incoming management will be of both general and specialist natures (Chapter 6). Despite the leadership and entrepreneurial attributes brought in by the team leader, certain skills gaps may remain; these will need to be filled to help in the management transformation and regeneration of the company (Chapter 6.5). Typically poor managerial skills may have resulted in the systems inherited from the previous owners being too rigid and no longer appropriate to the current context; they may have involved poor lines of communication both within the company and with the owner; there may have been a lack of long term management interest or motivation; incentives for reform may have been absent; procedures may have been slackly managed; and important management information may not have been produced (see eg case study of Slingsby, Appendix A9).

In a management buy-out the incumbent management should be expected to have a clear idea of the types of changes which need to be implemented to prepare for the new independence although some may suffer from a degree of inertia and lack of vision because of a low level of external experience. However, the immediate post buy-out period may be seen as one of consolidation when attention is paid to the key business areas of management, employees, trading partners, product range, cash flow and debtor management and investment. It is a period when the ability of management to effect change is much easier than normal (Wright, Normand, Robbie 1990, Chapter 8).

In contrast a management buy-in team may be in a more difficult position. Coming from outside, they will undoubtedly have ideas as to changes they would like to implement but new management does not have the detailed internal knowledge of incumbent management and may be unaware of serious problems within the target, particularly where it has been difficult to carry out due diligence procedures thoroughly. To some extent the effects of these factors may be mitigated through the majority of Team Leaders (Chapter 8.3) having experience of the same sector as the target: Zimmermann (1991) stresses the importance to performance of the new Chief Executive having experience of the sector. In the short term the new Team are also going to pay particular attention to the motivation of existing staff and the reliability of information which has been given.

It should be remembered that certain changes are virtually inevitable through the actual fact of ownership transfer. If the target was part of a Group, the severance of previous group arrangements, eg group purchase arrangements for insurance, motor vehicles, raw material inputs or administrative arrangements such as payroll administration will produce changes in certain areas in both buy-outs and buy-ins. Institutions will also have identified areas for improvement from their due diligence procedures, no matter whether it is a buy-out or buy-in, and the achievement of the Business Plan will depend on rapidly implementing such change.

TABLE 10.1: ACTIONS POST BUY-IN (Private MBI's)	% of Sample	Sample Size
Identified new markets	91.1	56
Added new products/services	83.9	56
Dropped existing products/services	47.3	55
Increased prices relative to competitors	58.5	53
Reduced prices relative to competitors	17.3	52
Changed advertising/promotion arrangements	77.2	57
Increased customer base	96.5	57
Changed a significant number of suppliers	48.2	56
Moved main company location	12.7	55
Changed the name of the company	47.4	57
Re-organised administrative/financial systems	94.7	57
Reduced stock level	58.9	56
Reduced average period of credit for debtors	73.2	56
Significantly increased capital expenditure	57.9	57
Sold surplus assets	35.7	56

Respondents to the questionnaire were asked whether they had engaged in various types of management action after the buy-in covering some fifteen areas (Table 10.1). The overall direction of response (60 percent of the possible actions had been implemented by more than half the respondents) indicated extremely thorough management analysis and action after buy-in and a much greater level of change than found in earlier surveys of buy-outs (see eg Wright, Thompson, Robbie 1992).

Types of action were then grouped (Table 10.2) to see if there were areas where new management appeared to have a high level of action, ie concentrating their efforts on actions which they believed were essential to performance improvement. Variables used in the analysis

TABLE 10.2: TYPES OF MBI ACTION						
	Management	Product/ Marketing	Admin	Finance (Working capital)	Finance (Fixed Assets)	All
Number of variables	7	7	3	3	6	26
Minimum	0	0	0	0	0	2
Maximum	7	7	3	3	6	22
Mean	2.86	4.46	1.03	2.17	1.78	12.31
Median	3	5	1	2	2	13
Mean as % all variables	40.9	63.7	34.3	72.3	29.7	47.3

were re-categorised into managerial changes, product and marketing, administration, finance (working capital) and finance (fixed assets).

On average buy-in Team Leaders did take action on about half the possible actions suggested (mean 47.3 % of total, median 50 % of total) which is a high degree of action taken in comparison with other surveys (see 10.6 below). Amongst individual categories particularly high levels of action were seen in control of working capital and marketing and product areas. Changes in fixed assets, which imply a longer time frame, were inevitably lower.

10.3 Administrative and Financial Action

Almost all respondents (94.7 percent) had re-organised administrative and financial systems reflecting the changed needs of the company in its new ownership form (Table 10.1). Some respondents had to transfer from the systems appropriate to a subsidiary of a larger group while some privately owned companies needed to upgrade the level of their financial information and control mechanisms to provide information to enable financial backers to monitor their investment.

The changes to administrative and financial systems were accompanied by specific actions to improve working capital management: almost three fifths (58.9 percent) reduced stock levels and almost three quarters the average period of credit for debtors (73.2 percent). Financial resource management was also improved through selling surplus assets (35.7 percent). Differences appear to exist with financial management in US LBOs. US evidence (eg Muscarella and Vetsuypens 1990) indicates a higher degree of unbundling of fixed assets but lower rates of improvement in working capital areas such as debtor and stock control.

Evidence from the earlier research survey of management buy-out performance again suggests more major changes occur in buy-ins than in buy-outs. In the survey of 1983-86 buy-outs only 43.2 percent of companies had experienced a reduction in debtor days while 20.8 percent had sold surplus equipment and 17.5 percent surplus land or buildings. Such actions can be seen to support theories which expect significant cash flow advantages to occur from buy-out (see Chapter 2.6)

There was also evidence of both increases in the overall capital base of the company through greater capital investment and /or acquisition of new subsidiaries. The responses to the survey indicated considerable attempts to restructure through increased investment, with a lower but still significant proportion making acquisitions.

Some 57.9 percent of the sample significantly increased capital expenditure (Table 10.1). Part of this increase may have been to enable replacement of assets which had been run down under the previous owners in addition to the straightforward expansion of capacity. This increasing level of capital expenditure would help to re-enforce the added efficiency being sought by the company and back up the growth being sought from new markets, the expanded customer base and the introduction of new products (see 10.3 below). The increase is greater than found in the buy-out survey, where only 43.7 percent of respondents had engaged in equipment purchases as a result

of the buy-out. The proportion of the sample making acquisitions was almost half that for increased capital expenditure at 29.3 percent (Table 10.3).

TABLE 10.3: CORPORATE ACQUISITIONS & DISPOSALS POST BUY-IN (Private MBI's)		
	% of Sample	Sample Size
New companies acquired	29.3	58
Intention to make purchase(s) over next 12 months	46.3	54
Activities closed down	12.7	55
Activities sold	6.0	50

Virtually half the sample (46.3 percent) also intended making purchases of companies over the following twelve months. This also allays criticisms of buy-outs resulting in significant reductions in capital expenditure (see 2.6)

In addition to the sale of assets noted above, a number of buy-ins had also rationalised their activities through closing down operations or selling subsidiaries. 12.7 percent of the sample had rationalised activities through closure but only 6 percent through sale.

As well as these basic finance and administrative actions after the buy-in, other fundamental operating changes were undertaken. Almost half the respondents had changed a significant number of suppliers. Surprisingly almost half had changed the name of the company despite the confusion, cost and temporary marketing problem that this might cause. A relatively small number had also moved the main company location- in some cases to a totally different region.

10.4 Product and Marketing Actions

Major changes were also noted in terms of Marketing and Product areas, which would be seen as essential for the generation of targeted turnover. More than 90 percent of respondents (Table 10.1) had identified new markets and made efforts to increase the customer base. Over four fifths

of the sample (83.9 percent) had added new products or services. However the need to rationalise or totally revise product lines was also strongly in evidence. Almost half the respondents dropped some existing products and services. The extent of both these changes was greatly above that recorded in earlier management buy-out surveys (Robbie, Wright, Thompson 1992) and above that is some US surveys (eg Muscarella and Vetsuypens 1990). Only 62.3 percent of buy-outs had introduced new products as a result of the buy-out and only 16.0 percent had ceased production of some of their range.

Position within the market was also altered through adjustments to advertising and pricing policy. Over three quarters had changed advertising arrangements and 58.5 percent of the sample had increased prices relative to their competitors. A small number 17.3 percent had however done the reverse pricing; case study interviews showed that this was for instance possible when too rigid a pricing policy had been pursued by the previous owner which resulted in sales being lost through lack of pricing flexibility (eg the case of Slingsby, Appendix A9)

10.5 Managerial and Employment Change and Incentive Systems

As well as the injection into the company of the team itself, other considerable managerial changes may be involved in a buy-in. The widespread restructuring that the survey has identified may need to be accompanied by the recruitment of specialist staff to fill a skills gap: indeed such gaps were recognised above (6.5). Furthermore against a background of considerable restructuring going on within the firm the actual practical strains of the first year of a buy-in may lead to existing management not being able to cope with the new types of demand, the actual recruitment of the additional staff and even members of the original buy-in team not being able to take the strain of their new position particularly where the team has not worked together before. As explained by Timmons (1990) for new ventures, management buy-ins must be seen as part of a dynamic process and their initial organisation and agreements between Team members may not

reflect actual contributions of individual Team members over time. Considerable managerial change is therefore to be expected.

TABLE 10.4: MANAGERIAL CHANGES POST BUY-IN (Private MBI's)	
	% of Sample
Buy-ins with managerial changes	74.1
(Sample size	58)
Of which -	
• Member(s) of the buy-in team leaving	16.3
• Recruitment of specialist senior staff	79.1
• Resignation of previous senior management	48.8
• Recruitment of own previous colleagues/contacts	41.9
• New senior managers taking equity	25.6
(Base for sample	43)

Virtually three quarters of buy-ins in the sample had experienced managerial change (Table 10.4) after the transfer of ownership compared to a half in the earlier survey of buy-out managers. As seen in the case of mergers and acquisitions (eg Walsh 1988, Martin & McConnell 1989) change of control initiated from outside in itself might be expected to indicate a high rate of management change. In contrast Muscarella and Vetsuypens (1990) saw relatively little managerial change in the period between a company going private and being re-listed.

The largest single change in both surveys was the recruitment of specialist senior staff although there was a marked difference between buy-ins and buy-outs. In a management buy-out the team usually already exists with proven skills in the environment of the particular firm. There may be a need to recruit specialist staff to fill functions previously carried out by Head Office or areas of weakness in existing management: such problems are however expected in the main to be assessed before the actual transaction takes place. In the buy-out survey, 24.0 percent of firms had recruited senior specialist staff. In contrast a much higher level of recruitment of senior specialist

staff may be required in a management buy-in to fill skills gaps in the generally small management teams. In addition some of the incumbent management in senior positions may not have the overall skills required to carry on tasks in the new independent era- for instance in a privately owned company, the owner Chief Executive may not necessarily welcome the resolute Finance Director who might be necessary in a buy-in or in the case of a subsidiary of a major plc, the local Finance Director may be responding more to instructions from a central finance department and not have the negotiating strengths which are necessary when dealing with institutions. Nevertheless the 79.1 percent of buy-ins which required to recruit specialist senior staff can be considered to be extremely high.

Such behaviour in management buy-ins also ties in with 'sharpbenders'. Grinyer, Mayes and McKiernan (1988, p 67) saw the change of Chief Executive being associated with the introduction of new functional executives who would manage effectively, share the new Chief Executive's vision and whom he could trust. Additionally fresh management introduces a new concept or definition of the business which provides a different strategic orientation for the firm (Hoffman 1989).

Technical and other weaknesses which may emerge in the incumbent team, the difficult personal relationships between the old and new management, and the pressures from the restructuring noted earlier are also likely to provoke tensions in buy-ins. In almost half (48.8 percent) of the survey buy-ins senior management who had been with the company before the transfer of ownership had resigned, a level seven times that recorded in buy-outs. The considerable reforms to existing practice described above are also likely to have put intense pressure on existing senior management who may have been responsible for supporting such operational policies for many years.

Buy-in team leaders can also be expected to recruit extensively from former colleagues and contacts whose abilities are personally known, ie could also trust (Grinyer et al 1988). Over two fifths of buy-ins with managerial changes recruited managers already known to the team. In a quarter of the sample with managerial changes, the new senior managers also took an equity stake.

As has been seen in the earlier surveys of buy-outs, changes may be expected in the composition of the team. In 16.3 percent of buy-ins where there had been managerial change, at least one member of the original team had departed. Perhaps surprisingly this was in fact slightly smaller than in the buy-out survey where 19.1 percent of respondents reported a change in composition of the team. Given the work, professional and personal relationships which the members of the team originally had this may seem surprising. In most cases the Team Leader would have been able to test the team in a working environment in his previous employment. However the reality of working in a new independent environment may be quite different from the family dominated private company or the large subsidiary of a plc. The ability to rely on a large back-up team may not be there or perhaps the Sales Director has actually to go out into the field to generate new business rather than just administer other sales staff. The team leader may thus feel that not all the team is performing to expectations or indeed in some cases it may be the reverse that the leader while capable in a divisional command structure cannot lead a company effectively when it is independent. It is not just the presence of a skills gap which may be important. Hofer (1980) notes the appropriateness of the hard nosed experienced cost cutter for operating turnround while the strategist/entrepreneur may be more suitable for high growth strategic turnarounds.

The new management team will be seeking to improve the efficiency of the company from the start and may have identified over staffing before the deal is completed. As in some buy-outs, part of the deal may involve a staffing re-organisation including redundancy which has been agreed with the vendor who may be bearing the costs in the transaction package. With a high level of

private buy-in sources being private individuals or privately owned companies, there may be the added problem of dealing with members of the family who are employed more on the basis of family retainer rather than viable employees and would not be welcomed by the new owners.

TABLE 10.5: EMPLOYMENT CHANGES (Private MBI's)	% of Sample	Base for Sample
Job losses effected on buy-in	37.9	58
Job losses on buy-in		
• Mean	16.4	21
• Median	5.0	21
• Standard Deviation	23.75	21
Job losses effected after buy-in	31.0	18
Job losses after buy-in		
• Mean	10.5	13
• Median	5.0	13
• Standard Deviation	13.43	13
Likely 3 year employment trend		
• Increase	77.6	58
• Remain the same	20.7	58
• Decrease	1.7	58

It is therefore not surprising to note that a high proportion of respondents (37.9 percent) reported that job losses had been effected on buy-in (Table 10.5) with an average loss of sixteen. Additionally further job losses in 31 percent of the sample were seen as necessary after buy-in although the mean loss was smaller.

Buy-ins appear more likely than buy-outs to effect job losses, both at the time of transfer of ownership and afterwards. However, over three quarters of buy-in leaders (77.6 percent) expected

employment levels to increase over the following three years (Table 10.3); only one respondent expected a decrease.

A further important aspect about the internal restructuring after buy-in is the level to which new and existing management and other employees are incentivised so that the company can best achieve the Business Plan. The Team itself and especially its Leader will be seen to be working under the incentives of equity ownership while also having to meet the requirements of the debt providers (Chapter 2.5.1). The possibility of increasing incentives to the wider body of employees through the extension of equity holdings may be one important method. Surprisingly, and unlike buy-outs, no firm in the sample had spread equity ownership to this extent.

TABLE 10.6: MAJOR CHANGES TO INCENTIVE SYSTEMS POST MBI (Private MBI's)

	% of Sample
Buy-ins making major changes to incentive systems	61.4
(Sample Size	57)
Of which	
• All employees	42.9
• Direct labour	42.9
• Sales	51.4
• Admin/finance	20.0
• Senior management only	37.1
• Directors only	11.4
Based on	
• Productivity	57.1
• Sales turnover	48.6
• Profits	85.7
• Return on capital	5.7
(Base for sample	35)

The majority of the sample, 61.4 percent, had though made major changes to other incentive systems (Table 10.6). The changes may apply to different groups of employees. In a little over half of these cases (51.4 percent) the change had applied to Sales staff. This overhaul of sales incentives be seen in the context of the major sales and marketing changes in the company noted above. Over two fifths (42.9 percent) of the companies changing incentives did so for all employees with the same percentage improving incentives for direct labour. Over a third had schemes which were applicable to senior management only but 11.4 percent solely to directors. Administrative and Finance personnel did not feature to the same extent as Senior Management overall, with only 20 percent of schemes applying to them.

The new incentive schemes were dependent on a number of factors often related to the relevant circumstances for each group of personnel, such as sales turnover and productivity. The overwhelming majority of schemes (85.7 percent), though, were dependent to some extent on profits. The need to achieve levels of profits agreed with institutions in the Business Plan or indeed to trigger a ratchet which was profit determined was clearly an important background factor to this. The second most important was productivity (57.1 percent), part of the overall strategy towards a more efficient and profitable organisation. Sales turnover was the next most important (48.6 percent) again illustrating the new methods being applied to sales generation.

10.6 Differences in Post Buy-in Actions with Management Buy-outs, Sharpbenders, Turnarounds and New Ventures

This Section extends the discussion of the descriptive statistics on management buy-in actions to determine the existence of statistically valid differences between buy-ins and buy-outs and other relevant studies such as sharpbenders, turnarounds and new ventures. Statistical distributions published in other surveys are examined in comparison with buy-ins using z-tests to compare areas of difference. Clearly comparisons have to be seen in the context of different time frames and variations which may exist in the exact wording of questions. Opler (1992) for instance has noted

the difficulties of comparing surveys of early and late 1980's LBOs because of differing economic conditions, pricing and interest rates. The survey of management buy-outs completed in 1983-85 covered a period when the economy was recovering from recession, many firms having had important cost cutting programmes during the recession and were now embarking into a more expansionary economic phase. In contrast the buy-ins were completed once expansion had started and up to the high point of the economic cycle. By the time of the survey they had been faced with high interest rates and declining demand and were having to implement relevant action. Analysis of problems faced by the buy-in companies (as opposed to the type of actions taken) is discussed in Chapter 11.

(a) Buy-outs

To identify the significant differences in post deal characteristics between buy-outs and buy-ins, Z-Tests were carried out on the results of this buy-in survey and the earlier 1983-85 CMBOR buy-out survey for certain leading changes which could be expected in both buy-outs and buy-ins (Table 10.7).

TABLE 10.7: DIFFERENCES BETWEEN BUY-INS AND BUY-OUTS

	Buy-ins		Buy-outs		Z-test
Type of Action	%	Sample size	%	Sample Size	
Added new products	84	56	62	182	3.0*
Dropped existing products	47	55	17	182	4.6*
Increase in capital expenditure	58	59	44	182	1.9
Job losses at time of transaction	38	58	25	182	2.0**
Member(s) of team leaving afterwards	16	43	19	182	0.4
Recruitment of specialist staff	79	43	24	182	6.8*
Reduced average period of credit for debtors	73	56	43	182	4.0*

Notes: *Significant at the 1% level; **Significant at the 5% level

Sources: Buy-outs derived from CMBOR 1983-85 buy-out survey, see Robbie, Wright, Thompson (1992)

These confirmed that significant differences do exist between buy-outs and buy-ins in terms of certain aspects of post transaction re-organisation. The addition of new products, dropping of products, recruitment of specialist staff and reduction in the average period of credit for debtors all produced Z-Test significance levels of 1 percent or better; job losses produced a significance level of 5 percent.

The lower level of change in buy-outs can be seen to be attributable to the retention in the main of all the previous management, most of them in the same functions as before. The assessment process by the venture capitalist (Chapter 2.4.4) will also have closely examined the performance of management in their existing positions; it will be assumed that they would not have been capable of managing a buy-out successfully if they had not been performing a satisfactory managerial function before- implying that there may be a limit to changes which are feasible in the short term. While the need to increase operating efficiency, generate cash flow to repay debt, the freeing of group restrictions (eg in the area of capital expenditure or marketing initiatives) and reduction in costs of compliance especially in the case of going privates does result in major changes, these are at a very lower level than buy-ins. The influence of the new debt and equity holders in buy-outs should result in both buy-outs and buy-ins having much improved cash management. Many buy-outs do appear to behave in this way, but the additional pressures in a buy-in including a potentially higher degree of existing under-performance results in a significantly higher degree of change. In terms of fixed assets, no significant statistical difference was noted in capital expenditure. Hofer (1980) and Hoffman (1988) both stress the necessity of changing the senior management to derive major improvements in performance.

Various differences were noted terms of management themselves and employees. Initial job losses were significantly lower (5 percent level) than in buy-ins, although it is possible that in some the vendor may be more likely to have engaged in employment restructuring before completion of a buy-out. The buy-in was significantly more likely to recruit specialist staff, reflecting the skills

gaps identified in the team. Perhaps somewhat surprisingly, there was little difference in team stability. This suggests not only that the team has been well chosen by the Leader but that the qualities required in introducing new management have the desired effect in terms of effecting other necessary management changes.

(b) Turnarounds

Comparisons are made with Slatter's survey of forty UK public company turnaround situations, ten of which were classified as unsuccessful in that they finally became insolvent (Slatter 1984). Comparisons are show between buy-ins and both the successful and the failed recovery companies. The date of turnaround was some years earlier than the buy-in survey, companies were in general larger and category headings may not necessarily have been identical between the two surveys.

TABLE 10.8: COMPARISON OF MANAGEMENT BUY-INS WITH SLATTER

TYPE OF ACTION	Slatter successful recovery (%)	Slatter failed recovery (%)	Buy-ins (%)	Z-Test mbi v Successful	Z-Test mbi v unsuccessful
Asset Reduction	93	50	36/73	2.34**	1.46
Change in Management	87	60	74	1.40	0.91
Financial Control	70	50	95	3.21*	3.91*
Cost Reduction	63	90	n/a	-	-
Debt restructuring/financial	53	20	n/a	-	-
Improved marketing	50	50	77/91	4.27*	3.33*
Organisational Changes	47	20	95	5.05*	5.91*
Product Market Changes	40	30	84	4.15*	3.67*
Growth via Acquisitions	30	10	29	0.10	1.34
Investment	30	10	58	2.48**	2.79*
Sample Size	30	10	52/57		

* Significant at the 1 percent level
** Significant at the 5 percent level
Note: Derived from Slatter (1984)

Despite the need for change in corporate turnround as identified by Slatter and in management buy-ins as hypothesised in this thesis, in only two out of a possible eight areas could significant differences between management buy-ins and successful turnarounds not be identified (Table 10.8). In two of these, asset reduction and investment, differences were noted at the 5 percent level.

Significant differences were seen in a wide area of administrative, financial and marketing/product areas despite some of the areas of action noted by Slatter having a very high take-up rate. For instance, while 70 percent of the successful Slatter companies had improved financial control the rate of action in buy-ins (95 percent) produced a difference which was significant at the 1 percent level. Organisational change, marketing and product market changes also returned differences at this level.

Less robust changes were noted in terms of financial changes involving fixed assets. Investment, although producing a difference with unsuccessful recoveries at the 1 percent level, produced one of 5 percent for the successful companies. There was no statistical difference in terms of growth via acquisitions. Overall asset reduction produced a difference at the 5 percent level with recovery companies.

No difference was found in the area of management change, the element of buy-ins undergoing management change being midway between the successful and failed recovery cases.

Overall management buy-ins can be seen to have involved more overall management change than in the turnaround companies examined by Slatter. Management buy-ins appear to involve a higher degree of financial, organisational, product and marketing change although actions on investment and acquisitions show less significant differences. Both types of transaction involve high degrees of management change.

(c) Sharpbenders

Comparison was made with Grinyer, Mayes and McKiernan's survey of 25 sharpbender companies as described earlier (Grinyer, Mayes and McKiernan, 1988). As outlined in the analysis of the Slatter survey, important differences do exist in the size of companies involved and the timing of the survey.

TABLE 10.9: COMPARISON OF MANAGEMENT BUY-IN ACTIONS WITH 'SHARPBENDERS'

Type of action	Sharpbenders		Buy-ins		Z-Test
	%	Sample Size	%	Sample Size	
Major Changes in Management	85	25	74	58	1.40
Stronger Financial Controls	80	25	91	57	2.11**
Reduced Stock Levels	10	25	59	56	4.12*
Reduced Debtor Period	10	25	73	56	5.25*
Significantly Increased Capital Expenditure	65	25	58	57	0.74
Sale of Surplus Assets	20	25	36	56	1.44
Activities Sold	35	25	6	50	3.26*
Acquisitions Made	50	25	29	58	1.84
New Product Market Focus	80	25	91	56	1.39
Rationalisation of Product Ranges	15	25	47	55	2.74*
More cost Effective Advertising	15	25	77	57	3.97*
Increased prices	15	25	59	53	3.64*
Moved main Location	10	25	13	55	0.38

* Significant at the 1 percent level
** Significant at the 5 percent level
Note: All figures rounded to nearest 5 percent
Note: Derived from Grinyer, Mayer & McKiernan (1988)

Financial control especially of current assets and liabilities again showed up major differences between buy-in actions and the comparator (Table 10.9). Stock and debtor control both showed differences at the 1 percent level although stronger overall financial controls was significant only at the 5 percent level, in all three areas buy-in action being higher. In contrast (and like Slatter, above) financial areas covering fixed assets and investment produce more similarities of action

between the two types of transaction. Sharpbenders were more active in making acquisitions and increasing capital expenditure, although neither was at the 5 percent level. Buy-ins were more active in selling assets although again the statistical difference was not significant. However sharpbenders were significantly more active in selling activities, over a third doing so compared to 6 percent of buy-ins. This may reflect the ability of a Buy-in Team to acquire assets which they wanted rather than having to acquire activities which they did not want; in the sharpbender case the company has the assets or activities anyway and has to design the appropriate restructuring activity, one of which might be the buy-in.

Important differences were also noted in the areas of product and marketing. Areas where no differences could be detected were major changes in management, the sale of surplus assets, acquisitions and new product market focus (Table 10.9). Buy-ins managers appeared to be more active in the areas of financial control, especially stock and debtor control, the rationalisation of product ranges, price changes and more cost effective advertising.

(d) Smaller Company Leveraged Buy-outs

Comparisons were also made with Malone's study of 56 US firms that experienced an LBO between 1981 and 1987 where the purchase price was less than $50 mn (Malone, 1989). Analysis again showed major differences emerging in both financial and marketing and product areas with UK management buy-ins showing for every management area identified a higher rate of post completion action (Table 10.10).

Although in the area of advertising and promotion arrangements no statistically significant difference emerged despite buy-in Teams being more active, highly significant differences emerged in increases in the customer base, identification of new markets and the addition of new products and services.

TABLE 10.10: COMPARISON OF MANAGEMENT BUY-IN ACTIONS WITH BUY-OUT AND VENTURE CAPITAL SURVEYS			
Type of Action	Buy-ins (%)	Malone (%)	Z-Test
Increased customer base	96.5	50	5.66*
Re-organised admin/financial systems	94.7	41	6.09*
Identified new Markets	91.1	41	5.67*
Added new products or services	83.9	50	3.82*
Changed advertising, promotion arrangements	77.2	64	1.53
Reduced average Debtor Period	73.2	32	4.32*
Reduced stock levels	58.9	55	0.43
Changed significant number of suppliers	48.2	11	4.25*
Sold surplus assets	35.7	34	0.11
Changes in Incentive Systems	61.4	43	1.94
SAMPLE SIZE	55/57	56	-

* Significant at the 1 percent level
Note: Derived from Malone (1989)

There was also far more attention paid in management buy-ins to the overall re-organisation of administrative and financial systems with over twice the percentage following this action compared to the US LBOs. While buy-ins also took significantly more action to control debtors, there was little difference in other forms of financial action such as the sale of surplus assets and the reduction of stock levels.

In the case of UK management buy-ins the re-organisation included a much higher level of supplier change (four times the US level) highlighting the ability of new management to change well entrenched patterns of purchase behaviour.

While changes to incentive systems in the UK management buy-ins were higher, they fell outwith the 5 percent significance level.

(e) Small And Large New Ventures

Comparison was also made with another US survey. Cooper, Woo and Dunkelberg (1989) surveyed 2845 members of the National Federation of Independent Business who had become business owners in 1984 or 1985. Comparison was made between 1202 smaller ventures (3 or less employees) and 201 larger ventures (8 or more employees). Widespread significant differences were noted in the majority of areas between the UK management buy-ins and the two categories of US new ventures (Table 10.11). Given the newness of the ventures, areas surveyed essentially covered marketing and product, early management changes and change of location.

TABLE 10.11: COMPARISON OF MANAGEMENT BUY-IN ACTIONS WITH COOPER, WOO & DUNKELBERG VENTURE CAPITAL SURVEYS

Type of Action	Buy-ins (%)	C,W,D Small (%)	C,W,D Small Z-Test	C,W,D Large (%)	C,W,D Large Z-Test
Added new products or services	83.9	50	8.12*	46	4.58*
Changed advertising, promotion arrangements	77.2	52	3.57*	45	3.86*
Increased prices relative to competitors	58.5	16	7.12*	22	4.51*
Changed Name of Company	47.4	6	9.11*	5	6.09*
Dropped existing products or services	47.3	20	4.43*	12	4.73*
Reduced prices relative to competitors	17.3	15	0.38	11	1.02
Moved main company location	12.7	16	0.73	19	0.95
Lost Part of Team	16.1	53	4.63*	30	1.52
SAMPLE SIZE	52/57	405(av)	-	92(av)	-

* Significant at the 1 percent level
Note: Derived from Cooper, Woo & Dunkelberg (1989)

In the area of product and marketing, the UK management buy-ins exhibited a higher degree of change than the US new ventures., The addition of new products and services, change in advertising, promotion arrangements, price increases relative to competitors and the dropping of existing products all produced differences at the 1 percent level with both the large and small US

new ventures. There was however little difference in the area of reduction of prices relative to competitors. Given the youth of the latter companies, and the need for them to adapt quickly to changing market circumstances to establish and rapidly consolidate their position, the extent of management buy-in action is notable.

In terms of the composition of the Team and senior management, both small and large US new ventures were more likely to lose part of the team than UK management buy-ins, although there was no significant difference in terms of management buy-ins and the larger companies in the US survey. There was little difference between the two surveys in the area of change of main company location.

TABLE 10.12: PROBLEMS ENCOUNTERED IN THE DEVELOPMENT OF THE BUSINESS- COMPARISON OF MBI'S WITH COOPER, WOO & DUNKELBERG SURVEY

Type of Problem	Buy-ins (%)	C,W,D Small (%)	Z-Test	C,W,D Large (%)	Z-Test
Decline in Market					
• no serious problem	9	9	0	10	0.28
• serious problem	36	60	5.76*	48	1.44
Competitive Pressures					
• no serious problem	6	4	0.69	8	0.33
• serious problem	20	45	3.50*	31	1.46
Family Demands,Health problems					
• no serious problem	4	3	0.40	2	0.73
• serious problem	59	60	0.14	69	1.24
Availability of credit or finance					
• no serious problem	11	9	0.47	17	0.90
• serious problem	36	60	3.32*	53	1.97**
Sample Size	53/56	418(av)	-	98(av)	-

* Significant at the 1 % level
** Significant at the 5 % level
Note both surveys based on responses on 5 point scales ranging from 'no serious problems' to 'serious problems'. In the case of Cooper, Woo and Dunkelberg (1989) figures, sample size refers to the average number of usable responses across all variables.

Cooper, Woo and Dunkelburg also described problems which may be found in the development of a business, grading the degree of problem on a 5 point scale. Comparisons can be made with

some virtually identical questions in the management buy-in survey (Table 10.12). Little relative change in terms of statistical difference was seen between the problems encountered by the larger new ventures and management buy-ins in the areas of decline in market, competitive pressures, family demands or health problems and the availability of credit or finance although the proportion of those in the US survey citing the last as a serious problem was, just, significantly different at the 5 percent level from the UK management buy-in respondents. Differences were however noted with US small venture respondents encountering serious problems in decline of market, competitive pressures and availability of credit or finance.

10.7 Conclusions

Chapter 10 has supported the view that following buy-in there is a period of considerable and intense managerial activity during which many key procedures are analyzed and changes made to established practices especially in the areas of sales and marketing and administration and finance. Changes implemented to enhance operating efficiency as well as to control financial exposure (revision of overall financial systems, stock and debtor reduction) imply the influence of Agency Cost Theory and debt bonding considerations. Despite the need to re-organise, buy-ins, in general, do not appear to belong to the 'unbundling' of assets school of thought. The entrepreneurial aspects involved in searching for new opportunities especially in the area of marketing and product development support the entrepreneurial element of the buy-in. Overall theories concerning the influence of new management in under-performing and turnround companies can be seen in the overall high level of action.

While high degrees of action were to be expected in management buy-ins, they are also assumed in other areas such as management buy-outs, early stage ventures and companies requiring turnround. Chapter 15.6 examined the extent of buy-in re-organisation compared to these other forms to assess whether buy-ins do represent a particularly active form of re-organisation.

This examination showed buy-in Team Leaders being, in general, extremely active in comparison with these other types of change, despite their own need for implementing re-organisation and new systems. In particular buy-ins can be seen to be particularly innovative in the addition of new products and services (significantly different at the 1 percent area compared with all the other surveys) and in overall changes to administrative and financial systems and especially working capital management. The extent of the higher degree of action compared with management buy-outs was considerable helping to confirm that major differences do exist between the two types of transaction.

It was also notable that significant differences did not exist in some of the areas. The managerial re-organisation in turnaround and sharpbender cases did not appear significantly different (reflecting the new ideas coming from outside) while no significant differences appeared in terms of acquisitions of new companies and only week differences in the area of capital expenditure and the sale of surplus assets.

For management buy-ins this greater overhaul of methods may be expected to lead to more efficient operation and help the long term profitability of the company although short term costs may be incurred. The sample appeared to be relatively expansionary in their changes to capital expenditure programmes, limited acquisitions of new businesses and their expected employment trends. As part of this overall restructuring and positioning of the firm, the majority of firms introduced new incentive systems which were reasonably spread throughout the company and had a strong profits bias. The implications of these for profit trends will be discussed in Chapter 16.

In terms of the hypotheses and propositions outlined in Chapter 3, support is found for the following:

(a) Management buy-ins are followed by a period of a high rate of change in a company which is especially pronounced in the areas of finance and product and marketing (P20);

(b) The level of financial actions taken after buy-ins is high in relation to improving working and total capital ratios reflecting the need to service debt. Fixed asset change (acquisitions, sell-offs, unbundling) was carried out to a lesser extent than working capital action (P21);

(c) Major marketing changes are implemented including a high degree of rationalisation of product ranges and the introduction of new advertising and promotion arrangements (P22);

(d) Managerial re-organisation is a particular feature involving a high degree of change relative to buy-outs and including the recruitment of both senior specialists and former colleagues as Directors (P23); and

(e) Comparison of actions with other types of transaction- management buy-outs, new ventures and turnround/sharpbenders- reflect some significant differences in the extent of financial and marketing changes (H5).

CHAPTER 11

POST BUY-IN PERFORMANCE AND REALISATION

11.1 Introduction

Key to the future of the company is the actual performance of the company in relation to the original Business Plan agreed with institutions. Chapter 2 reviewed both the theoretical reasons for expecting changes in profitability which may derive from both Agency and Entrepreneurship Theory as well as the results of major US, UK and European performance studies of management and leveraged buy-outs. Significant operating efficiencies, better cash management and overall asset management are to be expected. In the case of management buy-ins these may be enhanced through turnaround strategies being employed as well as the effects of the introduction of new management (Chapter 2.6.4). Expected high rates of action to improve performance have been confirmed in Chapter 10. Entrepreneurship theory would also imply that buy-in managers may wish to seize new marketing and product opportunities and through innovative behaviour to increase the turnover of the target company. Additionally factors such as education, family background and entrepreneurship experience may also affect performance. The need to exit and to control for exit was seen as an essential part of the buy-out life cycle theory (Chapter 2.6.6).

UK surveys of management buy-outs (eg Wright and Coyne 1985, Hanney 1986, Houlden and Brookes 1989, Bannock 1990a and Wright, Thompson and Robbie 1992) have all confirmed the short term improvements in profitability although longer term implications remain unclear. This survey is of companies which are still too young to produce long term evidence. Results may also be distorted by general economic, financial and business effects (eg Opler 1992) while rectifying reasons for earlier under-performance may take considerable time (eg Zimmermann 1991) and actual improvement may take longer than in buy-outs where under-performance issues may not be so pronounced.

Through the use of descriptive statistics concerning performance, Chapter 11 provides an introduction to the factors which are influential in buy-in performance. Factor, cluster and discriminant analysis are used in the two following Chapters to provide more statistically robust links between Team Leader and buy-in characteristics and performance. Chapter 11 uses the survey to assess:

(a) Performance indicators including differences in performance between companies and Team Leader characteristics (11.2);

(b) Identification of major problem areas (11.3);

(c) Evidence of further finance requirements (11.4); and

(d) Exit intentions and evidence of actual realisation (11.5).

11.2 Performance Indicators

The survey sought the general direction of performance within relatively broad parameters which were consistent with the earlier buy-out surveys conducted by Wright and Coyne (1985) and CMBOR. As such limitations have to be noted. First, as the population of buy-ins is still relatively small and only a few of the sample had completed two years trading and some had not even completed their first accounting year as an independent entity at the time of the survey, the results must be seen as indicative and an area for more detailed research in several years. Secondly the interpretation of initial performance may have varied, given the unequal lengths of period for which the sample buy-ins had been in existence. Thirdly as the questions related to performance ranges and were filled out by Team Leaders there may have been a subjective element rather than reliance on accounting data. Fourthly the results may also reflect general trends within the economy as a whole rather than just the underlying performance characteristics of management buy-ins.

Survey participants were asked how post buy-in performance of their company as measured by turnover and operating profit compared to the original targets of the Business Plan (Table 11.1).

There was considerable variation in the performance of the companies in the sample and major differences between performance as measured by operating profit and turnover. Despite deteriorating economic and financial conditions which were starting to affect the level of demand in the economy, management had more success in expanding their business in relation to their

TABLE 11.1: TURNOVER AND OPERATING PROFIT TRENDS POST MBI (Private MBI's)		
	% of Sample	
	Turnover	Operating Profit+
More than 25% worse	1.8	12.7
10-25% worse	21.1	20.0
0-10% worse	14.0	20.0
0-10% better	29.8	23.6
10-25% better	15.8	7.3
25-50% better	7.0	3.6
Over 50% better	10.5	12.7
(Sample Size	57	55)

+ Before interest

Note: Figures are actual compared with forecast/budget at the time of buy-in.

turnover plan than they had in achieving operating profit targets. Some 63.1 percent of respondents achieved turnover better than planned and one third were more than 10 percent ahead. The extensive marketing and sales changes noted earlier may thus have had a demonstrable effect in growing the company.

The trend in operating profit was however less satisfactory with over half the companies (52.7 percent) reporting operating profits worse than in the original Business Plan; for almost a third of companies operating profits were more than 10 percent below target. Expansion would appear to have been obtained at the initial expense of profit, but the effects of "skeleton in the cupboard" problems and the recruitment of specialist staff may also have increased costs and reduced profits.

TABLE 11.2: MAJOR ECONOMIC INDICATORS, 1988 Q1-A991 Q2				
Period	Consumer Expenditure % Change	GDP (Factor Cost) % Change	Industrial Production % Change	Bank Prime Lending Rate %
1988 Q1	8.6	5.1	4.1	8.67
1988 Q2	7.3	4.4	4.5	8.33
1988 Q3	7.2	3.6	3.4	11.50
1988 Q4	6.7	3.6	2.4	12.67
1989 Q1	4.3	3.1	1.6	13.00
1989 Q2	4.9	2.3	-0.4	13.67
1989 Q3	2.6	1.9	0.2	14.00
1989 Q4	2.4	1.6	0	15.00
1990 Q1	1.9	1.7	0.2	15.00
1990 Q2	1.6	2.4	2.5	15.00
1990 Q3	0.9	0.5	-1.6	15.00
1990 Q4	-0.6	-0.7	-3.3	14.00
1991 Q1	-0.9	-2.3	-3.0	13.17
1991 Q2	-3.1	-3.6	-5.8	11.67

Note: % Changes are on the same Quarter of the previous year

Sources: Economic Trends, International Financial Statistics

The period at the end of the 1980s and beginning of the 1990s was clearly one of considerable economic and financial change. As shown in Table 11.2, the earlier buy-ins in the survey benefited from a rapidly growing economy until mid 1988. Following interest rate rises which started in the Third Quarter of 1988 the economy became considerably weaker and by the time of the survey in February 1990 industrial production was effectively stagnant, GDP growth a third of that of two years earlier and borrowing rates for prime companies (most buy-ins would not be counted as such) 15 percent. These developments would clearly have had a major impact on both the profit and turnover trends of the companies and the actual performance achieved appears more creditable given the poor background.

It should be noted that the overall profitability trend may be considered even worse as the question was phrased in terms of operating profit. High interest rates would have resulted in net profits levels falling further short of targets than operating profits. Given the relevance of profit based ratchets to many Teams, this must be a cause of considerable concern.

The 1983/85 management buy-out survey revealed a significantly more favourable operating profit performance than shown for buy-ins with only 31.4 percent of respondents reporting trading profit worse than in the Business Plan and 39.5 percent substantially better (Wright, Thompson, Robbie 1992). Hanney (1986) in an earlier survey noted that 60.8 percent of her sample had increased turnover post buy-out and 80.7 percent profit. Comparisons need to be treated with caution as these buy-out surveys were carried out at a time of more favourable economic conditions. Since the buy-in survey was completed, there has also been a worsening in economic activity which could imply a further deterioration in the performance results of this survey.

Deviations in the performance of buy-ins may be related to several factors (Table 11.3) but it must be noted that causality is likely to represent a combination of factors rather than any single factor (see Chapter 13).

The year in which the buy-in was completed may be important because of the influence of varying economic, business and financial conditions. Buy-ins completed in 1986 and 1987 appeared to have more success in exceeding their targets than the later ones in the sample. There was some gap between 1987 and 1988 buy-ins but little difference between 1988 and 1989 buy-ins.

TABLE 11.3: DIRECTION OF TREND IN OPERATING PROFIT COMPARED WITH YEAR, SOURCE, SIZE, PREVIOUS PROFITABILITY AND CEO'S BACKGROUND (Private MBI's)

	Over 25% Worse	10-25% Worse	0-10% Worse	0-10% Better	10-25% Better	Over 25% Better	Base for Sample
Year of Buy-in							
• 1986	-	-	25.0	25.0	-	50.0	4
• 1987	12.5	12.5	25.0	12.5	25.0	12.5	8
• 1988	20.0	25.0	10.0	20.0	5.0	20.0	20
• 1989	8.7	21.7	26.1	30.5	4.3	8.7	22
Source of Buy-in							
• Private	18.9	18.9	21.7	18.9	8.1	13.5	37
• UK Divestment	-	18.2	18.2	36.3	9.1	18.2	11
• Other	-	28.6	14.2	28.6	-	28.6	7
Type of Sector							
• CEO-same sector	15.2	15.2	24.2	21.2	6.1	12.1	33
• CEO-other sector	9.1	45.5	9.1	9.1	-	27.2	11
CEO's Type of Education							
• MBA	20.0	40.0	20.0	-	-	20.0	5
• University degree	5.9	29.4	35.2	11.8	11.8	5.9	17
• Other higher education	28.6	-	14.3	14.3	14.3	28.5	7
• Professional qualifications	18.2	9.1	9.1	27.3	9.1	27.3	11
• 'A' levels	-	20.0	20.0	40.0	-	20.0	5
• 'O' levels/ none	14.3	28.5	14.3	28.6	-	14.3	7
CEO Previously In							
• Top UK 500 company	5.9	23.5	23.5	41.2	-	5.9	17
• Other UK plc	30.0	-	10.0	20.0	10.0	30.0	10
• Private company	14.3	23.8	14.3	14.3	14.3	19.0	21
• Overseas company	-	50.0	50.0	-	-	-	4
Size of Buy-in							
• Less than £1m	6.7	26.7	26.6	20.0	6.7	13.3	15
• £1-2m	11.1	11.1	11.1	22.2	22.2	22.3	9
• £2-5m	9.1	27.3	9.1	45.4	-	9.1	11
• 5-10m	33.3	-	-	-	33.3	33.4	3
• Over £10m	-	16.7	33.3	-	16.7	33.3	6
Profitability of Target at Buy-in							
•Loss maker	33.3	0	33.4	33.3	0	0	12
•At least breaking even	7.7	23.1	15.4	20.5	10.3	23.0	39

A further possible influence on performance could arise from the source of buy-in. Companies which have been part of a quoted group may have had more sophisticated control systems than in privately owned firms making it more difficult to conceal skeleton in the cupboard problems and providing more up to date management accounting information. In contrast privately owned companies may not have the same necessity to be subject to external control, the owner being able to take decisions without external interference. The results of the survey provide tentative evidence that performance post buy-in is better in companies which had previously been part of publicly owned groups rather than privately owned. While 59.5 percent of buy-ins from private sources had operating profits worse than plan, this was true of only 36.4 percent of divestments from UK quoted companies.

Failure to perform seemed to be considerably higher in smaller companies than large. Three fifths (60.1 percent) of buy-ins with initial value of less than £1 mn failed to reach planned levels of operating profit whereas over half (55.6 percent) of those greater than £5 mn had achieved operating profits at least 10 percent greater than planned. This may reflect unwillingness of venture capitalists to spend time and costs in monitoring smaller companies effectively as well as the higher probability of inadequate accounting systems resulting in hidden problems after completion (see Chapter 14).

Venture capitalists have stressed the role of new management to turn round poorly performing companies in a management buy-in (eg De Quervain 1989). However, the difficulties involved are reflected in the number of companies which were making losses before the buy-in failing to meet targets. Two thirds of companies which were showing an operating loss before the buy-in failed to meet operating profit expectations after buy-in and none achieved operating profit more than 10 percent better than target, compared to one third of companies which had been at least breaking even before buy-in.

The type and experience of team leader is also likely to be an important background factor although the size and kind of the previous company he worked for may be more important. Three factors were examined: educational background, the type of company the CEO had been working for immediately previous to the buy-in and whether this had been in the same industrial sector. Well educated managers, ie those with a university degree and or an MBA seemed to be associated with companies which were most likely to have missed target. 80 percent of the MBA's and 70.5 percent of those with university degrees failed to achieve targeted operating profit, worse than the results for those who left school with only 'O' levels or no formal qualifications at all. Those whose highest educational level was the obtaining of professional qualifications had the best record of any of the education groupings.

The type of company which the CEO worked for immediately previous to the buy-in could also be considered to be significant given the different types of problems, systems and controls in such companies. Post buy-in under-performance was virtually identical for both those who had been in a Top 500 company and those who had been working in a private company. Managers who had been working in a private company however were more likely to significantly outperform than those in a Top 500 company: 33.3 percent of those with a private company background had exceeded the Business Plan by at least 10 percent whereas only 5.9 percent of those from a Top 500 company had. The best performance however came from managers who had come from a non-Top 500 plc: 60 percent of these had out-performed the Business Plan operating profit and 40 percent had done so by more than 10 percent. In contrast all of the small sample of four CEO's who had worked previously in an overseas owned company failed to achieve the Business Plan levels of operating profits.

A further factor which was considered, a move by the Team Leader to a different industrial sector, produced tentative evidence to confirm that the chances of failing to achieve operating profit levels are greater when moving to a different sector. Nevertheless there was also some

incidence of very good performance also being achieved by managers who had moved sectors- 27.2 percent had achieved an operating profit improvement of over 25 percent.

While this section has examined the performance of various factors in univariate analysis, further aspects are analyzed through discriminant analysis in Chapter 13.

11.3 Major Problem Areas

Management were asked to score eight major factors which were thought likely to cause serious problems after buy-in, with serious ranking 5 and no problem 1 (Table 11.4).

TABLE 11.4: SERIOUSNESS OF POST-MBI PROBLEMS (Private MBI's)

	By % of Sample					Mean	Sample Size	Median	Standard Deviation
	Serious				No Problem				
	5	4	3	2	1				
Decline in overall market	8.9	23.2	16.1	16.1	35.7	2.54	56	2.0	1.414
Competitive pressures	5.5	13.0	33.3	27.8	20.4	2.56	54	3.0	1.127
Attitudes of employees	7.1	3.6	14.3	23.2	51.8	1.91	56	1.0	1.210
Availability of credit/finance	11.3	9.4	18.9	24.5	35.9	2.36	53	2.0	1.360
Cost of credit/finance	40.0	30.9	12.7	10.9	5.5	3.89	55	4.0	1.212
Family/personal demands	3.7	9.3	13.0	14.8	59.2	1.83	54	1.0	1.192
Discovery of "skeletons in the cupboard" type of problems	19.6	12.6	25.0	19.6	23.2	2.86	56	3.0	1.432
Exchange rate fluctuations	0	9.6	7.7	17.3	65.4	1.62	52	1.0	0.993

By far the most serious problem to emerge was the cost of credit and finance with 70.9 percent of the sample scoring it at the highest degrees of seriousness. The extent to which credit and finance was perceived as a serious problem inevitably reflects the period of high interest rates at the time of the survey in 1990. Some companies in the sample would have experienced a doubling in interest charges since completion of the buy-in making it more difficult to achieve their forecast profits. This reflects the over-leveraging and over pricing of buy-in transactions in

the late 1980's (see eg Dunne 1993). While there was a serious problem over the cost of credit and finance, there was less concern over their availability, only 20.7 percent of the sample rating it a serious problem (ie a score of 4 to 5). This to some extent allays fears that in an economic downturn how liquid and dependable firms supplying capital will prove to be (Palepu 1990).

The next most important category was the discovery of 'skeleton in the cupboard' types of problem. These cover a large body of problems which were not identified in the due diligence procedures and may be expected to arise as management frequently do not have the intimate knowledge of the target possessed by a management buy-out team; case study interviews also revealed that frequently they have inadequate access to the company during negotiations. These problems include such factors as: the presentation (knowingly or unknowingly by the vendor) of misleading or inaccurate accounting information; major changes in the operating and business environment since the last audited accounts; and the condition of stock, plant and equipment. Dealing with these problems diverts management time and effort and may incur greatly increased expenses. Theoretically the costs of skeleton in the cupboard types of problem can be limited through the use of warranties issued by the vendor; however in practice obtaining compensation under such arrangements may involve excessive costs particularly for the smaller buy-in.

Obvious problems exist in designing control systems to encourage management to be truthful about revealing information when observability of their actions is not possible (eg Chow, Cooper, Walker 1988). This may lead to the under valuation of the purchase price in the case of management buy-outs while leaving managers buying-in from outside with the possibility of being over charged through a reverse type of manipulation. In many ways this shows a reverse of the position in a management buy-out where managers themselves may be in a position to manipulate accounting and other information to depress prices. While in the 'Going Private' case, evidence casts doubt on the manipulation argument (eg De Angelo 1986), case study evidence has hinted

at the concealment or rescheduling of major new orders or the effects of restructuring as a measure of reducing the buy-out price (eg Wright and Coyne 1985).

Two other factors relating to the sector and the state of the overall economy were ranked equally seriously as problem areas: competitive pressures (mean 2.56) and decline in the overall market (2.54). These problems to some extent reflect the fact that many of the companies in the sample had already begun to experience the effects of the economic downturn at the time of the survey. These responses should also be seen in the context of the earlier questions on the characteristics of the industrial sector at the time of the buy-in where no respondents had felt that demand was unstable. Exchange rate fluctuations, which could be seen as another indicator of economic and financial pressures for some companies, were the least serious problem.

Human and personal aspects which could be considered to cause the management team problems had very low scoring. While the attitudes of employees to the new management may cause some uncertainty following the introduction of significant changes, over half the respondents (51.8 percent) reported no problem at all and only 10.7 percent an above average problem. This result bears out the impression obtained during case study interviews that in many cases the arrival of new management which is focused on solving problems and returning the target to health ends a period of uncertainty and is generally welcomed by the majority of employees (see eg the case of AGK, Appendix A8).

The management buy-in also places considerable family and personal demands on the team: apart from the financial burden of the loans which are required to be taken out to finance the managerial equity contribution in many cases, the time commitments required both during the negotiation of the buy-in and following when intense management effort is required as well as the need to move to a different region results in considerable personal/family demands. The scoring

on this issue showed that these problems were not widespread- only 13 percent claiming that they had more than an average degree of seriousness.

11.4 Finance Requirements

Survey results discussed above have shown that management found the cost of finance and credit a serious problem although constraints on its actual availability were not so great. Management buying-in frequently intend to expand their companies within a short time period. Such plans are likely to result in a significant requirement for further finance, either for capital expenditure, acquisitions or working capital for higher than budgeted sales growth. On a more pessimistic basis, further finance may be necessary to fund requirements through failure to meet original profit targets.

TABLE 11.5: REQUIREMENT FOR FURTHER FINANCE POST BUY-IN (Private MBI's)

	% of Sample
Companies requiring further finance	55.9
(Sample size	59)
Reasons for further finance	
• Greater Sales volumes	37.5
• Higher capital expenditure	37.5
• To make an acquisition	34.4
• Failure to meet original targets	40.6
• Other	15.6
(Base for sample	32)

Over half the sample (55.9 percent) had needed to raise additional finance since buy-in (Table 11.5), a much higher element than in the earlier buy-out surveys where one third of respondents had reported cash flow problems. Of those seeking further finance the most important element (40.6 percent) was failure to meet the original targets of the Business Plan. Case study interviews highlighted causes for this type of cash flow shortfall- the failure of working capital management

controls, under-estimation of the period required to run down excessive levels of over-age stock, costs associated with warranty claims, inadequate sales and the high cost of finance. The influence of this last factor is also implied from Table 11.2

However three other more positive aspects relating to expansion were almost as important: greater sales volumes, higher levels of capital expenditure and acquisition finance all emerged as significant factors backing up earlier comments as to the importance of the teams' expansion strategy.

TABLE 11.6: TYPES OF FURTHER FUNDING (Private MBI's)	
	% of Sample
Retained earnings	25.8
Personal equity subscription by MBI team	19.4
Institutional equity subscription	19.4
Introduction of new investors	12.9
Mezzanine debt	6.5
Overdraft	80.6
Other bank loan	38.7
Better working capital management	48.4
(Base for sample	31)

Further funding requirements were met from various sources (Table 11.6), by far the main one being bank overdraft (80.6 percent). Clearly there could be dangers if this method of short term finance was used in cases where longer term types were required. Better working capital management emerged as the second most important factor in further funding- the result of the improvements noted earlier in aspects such as debtor control. Other bank loans (ie, medium and long term facilities) were used by almost half those requiring further funding, in many cases clearly accompanied by an overdraft facility. Retained earnings were important in a quarter of cases. The role of mezzanine debt in additional funding was used by only two companies in the survey.

Additional amounts of equity finance played a relatively minor role. Less than a fifth of those requiring further finance had obtained further equity from either personal or institutional sources (19.4 percent each). Nevertheless the terms of the refinancing which had been agreed had led to a dilution in the equity stakes of management in a quarter of the cases. For major expansion schemes there was limited evidence of the introduction of new investors (12.9 percent). It is, of course, arguable that some measure of interest protection should have been incorporated in the buy-in financing structure, which would have helped to offset the effects of increasing interest costs.

11.5 Exit Intentions and Realisation

In the longer term, as discussed in Chapter 3.4, financial backers and management will seek full or partial realisation of their investment. In the short term it has been noted that the financial commitment to the buy-in company has in a significant number of cases been increased through further equity subscription or extension of bank facilities.

TABLE 11.7: EXIT INTENTIONS AT TIME OF BUY-IN
(Private MBI's)

	% of Sample
Stock market flotation	43.6
Sale to a third party	52.7
Re-structuring/second buy-out/releverage	14.7
Family succession	7.3
No particular exit method favoured	18.2
No exit intention at all	14.5
(Sample size	55)

Note: Because of multiple responses, exit intentions add up to more than 100%.

Buy-in teams may consider several possible exit routes. Participants were asked to state their original favoured exit intentions (Table 11.7). The most favoured routes were a trade sale (52.7 percent) or a Stock Market flotation (43.6 percent). This order is in contrast to the earlier survey

of buy-outs when flotation (with particular emphasis on the USM) was the most preferred exit route. To some extent the difference between the two surveys reflects changing financial circumstances- since 1988 few buy-outs and buy-ins have floated on the Stock Market and trade sales have become considerably more frequent (Chiplin, Wright, Robbie 1992).

There is also the question of the long term motivation of the buy-in manager. Responses to the survey indicated that a number of buy-in managers were keen to maintain the company as an independent entity for as long as possible. Some 14.5 percent claimed that they had no exit intention at all while 7.3 percent were looking to family succession. One option which emerged in the late 1980's, restructuring involving re-leverage or a buy-out under which gearing levels are increased and major distributions made to equity investors with perhaps the equity investors being replaced by others, was favoured by 14.7 percent of the survey participants.

Since buy-in some teams had changed their intentions as to exit in the light of actual plan achievement and changes in financial market circumstances. The attractiveness of a Stock Market float for the earlier companies in our sample had declined significantly. Eleven buy-ins in the sample reported a change, the most major shift being towards a trade sale. Five of the sample who had originally intended to either float the company or engineer a trade sale had narrowed this down to a trade sale, one had changed from a float to a trade sale and one who originally favoured no particular method had later selected a trade sale. One each of the sample had shifted to a stock market flotation, a reverse-in to a quoted company, a break-up sale and family succession.

This change in intentions among buy-in managers is matched by experience in buy-outs. Few of the buy-outs in the survey of 1983-85 buy-outs who had originally expressed the intention to float actually did so, the majority of exits occurring within three years of the survey being by trade sale.

At the time of survey four buy-ins in the sample had actually achieved an exit, two through a stock market quotation/ reverse-in to a quoted company and two through a trade sale. By September 1991 one other has completed a trade sale which was under discussion at the time of the survey and nine others had gone into receivership. By September 1992 the total numbers exiting through trade sale had risen to 4 (6.8 %) and a further 3 through a float or reverse-in (5.1%). However 13 (22.0 %) had been placed in receivership. In the following 12 months to September 1993 a more encouraging pattern emerged reflecting improved economic and financial conditions following the withdrawal of the UK from the ERM: there had been no further receiverships while the number of flotations had risen to 4 and trade sales to 6.

TABLE 11.8: BUY-IN EXITS, BY YEAR OF BUY-IN (%)					
Buy-in Year	Float	Trade Sale	Receivership	No Exit	Sample Size
1986	20.0	-	20.0	60.0	5
1987	-	20.0	-	80.0	10
1988	5.0	40.0	20.0	55.0	20
1989	8.3	-	33.3	58.4	24
1986-1989	6.8	10.2	22.0	61.0	59

Analysis of exit patterns by year (table 11.8) show the poorest exit performance being for those buy-ins completed in 1989, ie at the point where the economy was clearly heading into recession, interest rates were high but entry PE ratios were also excessive. The short period to receivership for these companies does however give some strength to the Jensen (1991) argument that buy-out governance arrangements allow the more active investor to assess the position quicker than in more conventional structures and preserve something of value in the company before all value is lost.

11.6 Conclusions

Despite the limitations noted concerning the relevant survey questions, the initial performance characteristics of buy-ins have proved disappointing compared to buy-out surveys which asked similar performance direction questions (eg Hanney 1986, Wright, Thompson, Robbie 1992) and investigations based on accounting data in both the UK (eg Bannock 1990a, Houlden and Brookes 1989) and the US (Kaplan 1989, Smith 1990, Singh 1990, Muscarella and Vetsuypens 1990, Bull 1989), all of which have indicated positive overall profit effects even if in some cases longer term aspects may be more mixed (Houlden and Brookes 1989). Results need however to be seen in the particular circumstances of deal completion in the late 1980s (see eg Jensen 1991, Opler 1992) when mergers and acquisition markets may have been overheated leading to high degrees of leverage in transactions where pricing in retrospect may have been too high. As can be implied from the economic and financial data in Table 11.2, the sharp economic downturn accompanied by sharp increases in interest rates in the short period between completion of some of the later survey companies and the actual survey is likely to have further affected performance with Teams remarking on the problems caused by the cost of bank finance. It has also been a major cause behind the high level of receiverships indicating the considerable risk factors involved in buy-ins. Significant refinancing has also been required (Chiplin, Wright, Robbie 1992). Despite these negative features, a minority of buy-ins did manage to outperform and several successful realisations were achieved. There is also evidence that buy-in failure was achieved at a relatively early stage showing venture capitalists pursuing an active role and trying to preserve something of value in the company.

Propositions concerning management buy-in performance, problem areas and realisation contained in Chapter 3 can be supported as follows:

(a) Better performers are likely to be associated with entrepreneurs who are working in the same sector (P17a) although contrary to part of the same proposition those with better educational qualifications did not appear to be associated with better performance;

(b) Better performers appeared to be associated with medium rather than small sized companies which had been subsidiaries of significant parents and had been profitable at the time of the buy-in;

(c) Like many new ventures the most serious problems were of a financial nature particularly the availability and cost of credit and finance (P16); and

(d) A particularly serious problem derived from information asymmetry when completing the transaction which resulted in major problems emerging after completion which were not revealed in due diligence procedures (P19).

Further support is also given to Hypothesis H6 that buy-ins have a higher risk structure than buy-outs and are especially prone to receiverships.

These initial findings will be developed further in Chapter 13 where discriminant analysis will be used to predict failure using some of the important variables which have been identified.

CHAPTER 12

A TYPOLOGY OF BUY-IN TEAM LEADERS

12.1 Introduction

Chapter 12 has illustrated the relative importance of various motivational factors of the Team Leader while Chapter 6 described their demographic characteristics such as age and entrepreneurial background. The Entrepreneurship literature survey included the development of studies into typologies of entrepreneurs (Chapter 2.3.5), which indicate the existence of at least two main types of entrepreneurs- 'craftsmen' and 'opportunists'.

This Chapter develops data from the questionnaire survey to investigate the existence of possible types of management buy-in Team Leaders. An R-Mode Principal Components Analysis is used to determine a group of underlying factors (12.2); this is followed by cluster analysis to identify the distinct Team Leader types (12.3). Statistical differences between types of Team Leaders are tested and the possibility of significant differences between Team Leaders in terms of subsequent target performance and managerial action are assessed (12.4). Similar techniques are then applied to data from an earlier survey of management buy-outs (12.5) to illustrate perceived differences between the types of Managers undertaking these two different forms of corporate restructuring (12.6).

12.2 Standardisation of Buy-in Team Leader Characteristics using Factor Analysis

Factor analysis enables a relatively small number of factors to be identified which can then be used to represent relationships among sets of many interrelated variables allowing underlying, but not directly observable, constructs to be identified from a set of observable variables (Norusis, 1985, Alt 1990). Each variable is expressed as a linear combination of a small number of common factors which are shared by all variables and a unique factor that is specific to that variable. As

a first stage the Team Leader characteristics were standardised using Principal Components Analysis. The purpose of this was to produce new combinations of the original data, which may then be used as new independent and orthogonal reference axes (or variables) in a typology of Team Leaders using Cluster Analysis, reduce the number of variables under investigation and for the exploratory purpose of detailing and identifying groups of inter-related variables.

Previous empirical work has used a variety of approaches in identifying the dimensions of entrepreneurs. Socio-demographic data have been extensively used (see eg Westhead, 1990) as a surrogate for motivations, although it should be recognised that such data may provide a weak proxy for true motivational data. Following detailed examination of the data set, it was considered appropriate to focus primarily on the data which provided direct measures of motivation (as shown in Table 7.1) supplemented by variables relating to managerial experience, financial commitment, entrepreneurial experience and age[1]. The motivational factors employed were based on previous survey questions carried out on management buy-outs (eg Wright, Thompson, Robbie 1992) and therefore could be considered to represent a tested and consistent approach. Care had been taken in framing the questions to ensure as far as possible reliable answers to questions which would show uniformity of interpretation by respondents (Chapter 4.5). The reliability of the motivational variables was then tested using Cronbach's Alpha and standardised item Alpha (SPSS 1998). This process produced an Alpha of 0.6316 and Standardised Item Alpha of 0.6104.

To facilitate the use of factor analysis, certain of the categorical variables reported earlier were re-coded to represent interval data. Thus managerial background was measured in terms of breadth of experience on a range from specific functional and general management experience

[1] An alternative approach would have been to rely on variables describing entrepreneurial and or company characteristics thereby excluding motivational aspects. Factor and subsequent cluster analysis was carried out using a selection of such variables as an alternative, but did not produce results which appeared to be statistically superior. Consequently discussion in this Chapter refers to the combination of motivational and a few basic variables reflecting the entrepreneurs background.

through to only general management experience and finally only specific functional experience. Financial commitment to a buy-in was measured on a scale based on lower risk/personal wealth to higher risk/personal debt. Similarly entrepreneurial experience was measured on a scale from none at all, through to share ownership of a previous entrepreneurial venture and MBO/MBI ownership experience. Additional re-coding was carried out to reduce undue influence of missing values and given the relatively small numbers in some response categories to provide more meaningful intervals, eg educational background was reduced to those with a degree, other further education or professional qualifications, and school leavers.

This data set was subject to a factor analysis using principal components analysis and an oblique rotation. This method in comparison to orthogonal rotation, while similarly preserving the commutabilities of the variables, does not produce identical factor loadings and factor variable coefficients. Oblique rotation has been perceived to yield substantively meaningful factors (Norusis 1985). Initially the correlation matrix for all variables used was computed. Bartlett's test of sphericity was used to test the hypothesis that the correlation matrix was an identity matrix. This produced a value of 202.8, with a significance of .00000. Additionally the Keyser-Meyer-Olkin measure of sampling adequacy was examined as a measure for comparing the magnitudes of the observed correlation coefficients to the magnitudes of the partial correlation coefficients; the value of 0.57 was considered adequate for proceeding further. To assess the significance of individual variables which had been used, the communality ratings were examined. The extracted factors, after the oblimim converged in 79 iterations, resulted in six factors being extracted accounting for 69.2 percent of the original variance (Table 12.1). Interpretation of the individual factors is given below and is seen to have similarities with other studies of entrepreneurship, particularly in terms of opportunist-craftsman characterisations (Woo, et al, 1991).

TABLE 12.1: MANAGEMENT BUY-IN CHARACTERISTICS: FACTOR ANALYSIS						
Description	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5	Factor 6
Commercial Opportunity	.77177					
Develop Own Strategy	.60012	.50179				
Do Own Work	.51867	.39307				
Build Successful Organisation	.50447			-.32994	.41268	-.33224
Lack of Opportunity		.72772				
Avoid Working for Others		.71768				
Previous Ownership Experience		-.59613	.42488	.35503		
Frustrated by Head Office		.59613		-.40871	.39193	
Capital Gain			.87835			
Attitude to Risk	-.33527		-.62741			
Acquisitive			.57309		.32073	-.30681
Breadth of Managerial Background				.85084		
Age					-.80015	
More Money			.37048		-.41663	
Made Redundant						.93752
Eigen Value % Variance Cum. % Var.	3.16691 21.1 21.1	2.13315 14.2 35.3	1.65792 11.1 46.4	1.32419 8.8 55.2	1.08481 7.2 62.4	1.01450 6.8 69.2

Factor 1 involved people who were motivated by a desire to do their own kind of work developing their own strategy and building a successful organisation and also having spotted a specific commercial opportunity. This factor could be labelled 'commercial ambition'.

Factor 2 involved people who felt frustrated in their existing employment- the effects of Head Office control and lack of opportunity- and who were keen to develop their own strategy and avoid working for others. They had little entrepreneurial experience. This factor could be labelled 'independence'.

Factor 3 included Team Leaders who were not so influenced by frustrations of their current employment, but were interested in financial gain, had some previous entrepreneurial experience and were acquisitive. They were also more reliant on their own wealth than having to borrow funds. This factor was labelled 'investment'.

Factor 4 included Team Leaders who had also had significant previous entrepreneurial experience but were now not so motivated by financial gain and were not concerned about the need for independence. They had high familiarity with specific management functions. This factor was labelled 'Practicality'.

Factor 5 reflected younger entrepreneurs who were not influenced by pecuniary influences although there was a small redundancy element. This group were seeking to build a successful organisation and were reasonably acquisitive. This factor was labelled 'personal ambition'.

Factor 6 was highly motivated by redundancy with some desire to be rid of Head Office control and to avoid working for others. They showed little concern as to building a successful organisation. This factor was labelled 'push'.

12.3 Determination of Team Leader Clusters

Having determined six basic factor types from the original 59 Team Leaders, cluster analysis was used to identify distinct Team Leader types which had maximum between group variance and minimum within group variance. This method effectively groups the Team Leaders based on

similar emphasis in each of these six background dimensions and produces clusters of Team Leaders who have similar entrepreneurial backgrounds (see eg Alt (1990) Chapter 5 for an explanation of the use of cluster analysis).

In order to establish whether distinct homogenous groupings of entrepreneurs exist among buy-in Team Leaders, the factor scores for each respondent were subject to a cluster analysis using both iterative partitioning and hierarchial clustering methods. Both approaches produced a high degree of similarity in the classification of individual cases suggesting that the resulting cluster solutions were reasonably robust.

TABLE 12.2: CLUSTER CHARACTERISTICS (ITERATIVE PARTITIONING)						
Mean Scores	Whole Sample	Cluster 1	Cluster 2	Cluster 3	ANOVA F-test (sig)	Differences between clusters 2-sample T-test
Commercial ambition	0.02	0.33	-0.51	0.21	0.062	1,2 2,3
Independence	0.01	0.43	0.40	-0.17	0.115	2,3
Investment	-0.01	-1.25	-0.34	0.24	0.008	1,2 2,3
Practicality	-0.04	-0.07	-0.13	0.00	0.912	-
Personal ambition	-0.02	0.48	-0.77	0.24	0.002	1,2 2,3
Push	0.00	3.21	-0.48	-0.05	0.000	1,2 2,3 3,1
Number	56	3	15	38		
Percentage	100	5.4	26.8	67.8		

The characteristics of the individual clusters produced by the iterative partitioning method are outlined in Table 12.2 and show the presence of three main cluster groupings. A notable feature was the presence of a very small group representing three members only. Careful examination was

made of this grouping through efforts at clustering at different levels; nevertheless this small grouping was present consistently throughout these variations. Differences between mean scores across the cluster are indicated in the table based on the F-statistic from a one-way analysis of variance and a series of individual two sample T-tests. Only Factor 4 (practicality), and to a lesser extent, Factor 2 (independence) show no differences across the clusters.

TABLE 12.3: CHARACTERISTICS OF MBI CLUSTERS					
VARIABLE	GLOBAL MEAN	STD	CLUSTER 1	CLUSTER 2	CLUSTER 3
Own kind of work	3.4643	1.53	4.333*	3.600	3.3421
Head Office Control	2.5536	1.70	4.0000*	2.3333	2.5263
Lack of Opportunity	2.5536	1.74	2.3333	2.8667	2.4474
Avoid working for Others	3.3929	1.64	5.0000*	3.6000	3.1842
Develop own Strategy	4.2321	1.22	4.0000	3.9333	4.3684
Specific Commercial Opportunity	3.6429	1.33	3.6667	2.7333*	4.0000
Acquisitions vehicle	3.6607	1.42	1.6667*	3.2000	4.0000
Successful organisation	4.2679	1.17	3.0000*	3.8667	4.5263
Earn More Money	3.0893	1.50	1.6667*	3.2667	3.1316
Capital Gain	3.6607	1.42	1.6667*	3.4667	3.8947
Made Redundant	1.3571	1.07	5.0000*	1.0667	1.1842
Chief Executive's Entrepreneurial Experience	1.4821	0.91	1.0000*	1.0667	1.6842
CEO's Financial Resources	3.5000	1.39	4.3333*	4.3333*	3.1053
CEO's Background	1.6964	0.74	2.0000	1.6000	1.7015
CEO's Age	2.7679	1.06	3.0000	3.4667*	2.4737

Each Cluster can be seen as representing a particular type of entrepreneur and can be interpreted using both the characteristics shown in the relative cluster mean scores for each Factor earlier identified but also through examining the cluster means for each of the variables which were used (Table 12.3). Cases where cluster means deviate by more than half a standard deviation from the respective global mean are underlined to highlight the distinguishing characteristics of each of the clusters (Openshaw 1983).

The first and the smallest Cluster with only three members showed a very high rating of Factor 6 (the 'push' factor), although there is also relatively high evidence of Factor 5 (personal ambition) and Factor 1 (commercial ambition). They could thus be expected as well as acting defensively because of the redundancy factor to have a high independence element (in terms of wanting to do their own kind of work and avoid working for others) while not being motivated by financial income or gain considerations, the desire to build a successful organisation or being acquisitive. Examination of this Cluster's variable means showed deviations by more than half a standard deviation from the respective global means on ten out of the fifteen variables used. They had maximum (ie 'most important') ratings for motivation through avoiding working for others and being made redundant. They had not had previous experience of company ownership, were older than average and were more reliant on finance through borrowing and tended to have specialist rather than purely general management backgrounds. They can best be described as belonging to a group of 'push' entrepreneurs.

Cluster 2, the second largest group with 15 members, showed high influence of Factors 2 ('Independence') but high negative ratings for Factors 1 ('commercial ambition'), 5 ('personal ambition') and 6 ('pushed'). While there was a strong desire to do their own kind of work and they felt a lack of opportunity in their previous environment, this did not result in strong monetary influences or a desire to build a successful organisation. They could therefore be expected to want independence. They were also likely to be significantly older. Analysis of variable means (Table 12.3) showed them also to have low redundancy ratings, to be reliant on borrowed funds and to have a low rating for specific commercial opportunity. In most respects they typically represent the 'craftsman' type of entrepreneur.

Cluster 3, the largest cluster with 38 (67.8 percent) of the sample, was dominated by individuals reflecting Factor 1 (commercial ambition), Factor 3 (investment) and Factor 5 (personal ambition). Factor ratings were relatively low only showing a relatively high rating for Factor 2

(implying financial risk, lack of existing opportunity and frustration at Head Office control). They also appeared to have earlier entrepreneurial experience and were more reliant on their own personal wealth rather than borrowed funds. None of the variable averages deviated by more than half the global standard deviation from the global means, reflecting the relative size of this group. Further analysis from the variable means confirmed them to be younger but also the most likely to have had some earlier entrepreneurial experience and to be seeking specific commercial opportunity, to have had average General Management background, to be looking for financial gain and to be acquisitive. With the exception of the age characteristic, they fall most appropriately into the 'opportunist' classification of entrepreneur.

TABLE 12.4: SIZE OF MBI CLUSTER TARGET FIRMS				
VARIABLE (MEAN)	GLOBAL MEAN	CLUSTER 1	CLUSTER 2	CLUSTER 3
Employees (number)	125.7	17.3	116.9	138.7
Operating Profit (£'000)	196	-3	-312	397
Turnover (£'000)	6,949	650	7,335	7,324
Price Paid (£'000)	2,859	471	3,080	2,962

Examining characterises of the target companies selected by the members of the individual clusters, it was noted that Cluster 1, the 'push' group, were associated with small companies in terms of employment, turnover and price; they were marginally loss-making (Table 12.4). Cluster 2, the 'craftsmen' and Cluster 3, the 'opportunists', were associated with medium sized companies which were close to each other in terms of average turnover, price and to a lesser extent number of employees. However the Cluster 2 target companies were on average loss-making while those in Cluster 3 were profitable.

A one-way analysis of variance suggests significant differences on 4 out of the six characteristics used to identify the clusters while a 2-sample T-test suggests that clusters 2 and 3 differ on 5 out

of the 6 characteristics. In addition to showing some consistency with entrepreneurial types as identified in the existing literature, these clusters also correspond with what might be expected given the approaches adopted by venture capitalists (3i, 1992a).

12.4 Other Differences Between Buy-in Team Leader Clusters

Given that significant differences have been identified across these clusters, the possibility of other differences which might arise in the management buy-in process were investigated. These reflected areas where earlier discussion in Chapters 2 and 3 had shown that differences may exist in ventures managed by different types of entrepreneurs reflecting not only personal and entrepreneurial background but also factors relating to the target company. These included performance, team factors, control mechanisms, management actions, team and management re-organisation, further financial requirements and realisation objectives and achievements, and the type of company. It should however be noted that the small size of the 'push' cluster may distort tests of statistical significance. To reduce the effects of excessive 'empty' cells in cross tabulation Chi-Square tests, further re-coding was done to certain variables to produce more compact interval data whilst retaining the direction of effect. Consideration was given to limiting the analysis to differences between the opportunist and craftsman types and excluding the very small 'push' factor. Trial analysis with certain variables did not however appear to bring major improvements to the outcome. Results are shown in Table 12.5.

(1) Performance

Operating profit and turnover were recoded so that they were measured on a better or worse basis compared to Plan. Neither operating profit nor turnover produced significant differences between the cluster types. While Cluster 2 were 53.8 percent better than operating profit Plan as opposed to 50 percent for Cluster 3 and 66.5 percent for Cluster 1, the level of significance was p=0.85. Turnover produced a more interesting result although the level of significance (p=0.24) remained unacceptable.

TABLE 12.5: MANAGEMENT BUY-INS: SIGNIFICANT AREAS OF DIFFERENCE BETWEEN CLUSTERS			
VARIABLE	3 CLUSTER CHI-SQUARE	3 CLUSTER CHI-SQUARE SIG	COMMENTS
Profit Compared to Plan (Better/worse)	0.33	0.85	C1 66.5% worse, C2 53.8 C3 50/50
Turnover Compared to Plan (Better/worse)	2.83	0.24	All C1 better, C2 50/50, C3 65/35
THE TEAM			
Knew each other before	6.80	0.03	C1 0%, C2 80.0, C3 90.3
Marketing Skills Gap	9.31	0.01	All C1, C2 6.7%,C3 23.5%
CONTROL MECHANISMS			
Bank Covenants	13.05	.01	C3 32.4% restrictive,C2 13.3%, C1 0%
Personal Guarantees	10.34	0.04	C1 33.3% useful, C3 70.6%
MANAGEMENT ACTIONS			
Increased customer base	5.40	0.07	13.3 % C2 did not
Changed significant number suppliers	6.96	0.03	73.3 % C2 did not, 42.9%, C3 did not, All C1 did
Re-organised admin and financial systems	4.98	.08	66.7% C1, 93.3% C2, 97.2% C3 did
Subsequent acquisitions	6.94	0.03	C3 39.5% did but only 6.7 % C2, nil C1
TEAM/MANAGEMENT RE-ORGANISATION			
Incentives for Directors only	5.32	0.07	C2 more likely, 60%; C1 nil, C3 10%
Incentives for All Sales	9.42	0.01	None C1, All C2
FINANCIAL REQUIREMENTS			
Further Finance Required	4.65	0.09	C1 none, C2 53.3%, C3 63.2%
REALISATION OBJECTIVES & ACHIEVEMENTS			
Exit by Stock Market Float	6.47	0.04	C1 nil, C2 100%, C3 64.3%
Actually exited	3.60	0.17	Nil C1,C2 33.3%, C3 50.0%
Failure/restructure v sale/alive	4.86	0.09	C1 nil, C2 13.3%, C3 39.5% failure/restructure
THE COMPANY			
Turnover	11.12	0.03	C1 all less than £1m, C2 33.3% greater than £5m, C3 44.7% greater than £5m

Note: C1=Cluster 1; C2=Cluster 2; C3=Cluster 3

(2) The Team

There was a significant difference in whether the team had known each other before (Chi-square=6.80, p=0.03) with Cluster 1 not knowing each other but 90.3 percent of Cluster 3. All of Cluster 1, buying the smallest companies, had a marketing skills gap which only occurred in 6.7 percent of Cluster 3 (Chi-square=9.31, p=0.01).

(3) Structuring and Control Issues

Significant differences were noted in terms of attitudes towards the provision of personal guarantees (Chi-square=10.34, p=0.04) and bank covenants (Chi-square=13.05, p=0.01).

(4) Post Buy-in Managerial Actions

A wide range of managerial actions was examined. Some marginal significant difference was seen in terms of re-organisation of administrative and financial systems (chi-square= 4.98, p=0.08). Certain other actions appeared to illustrate important differences- increasing customer base (Chi-square=5.40, p=0.07), subsequent acquisitions (Chi-square=6.94, p=0.03) with Cluster 3 being the most likely to acquire but none of Cluster 1 and changing a significant number of suppliers (Chi-square=6.96, p=0.03).

(5) Post Buy-in Team/Management Re-organisation

Significant differences in managerial changes post buy-in were noted only in terms of incentive system introductions: those for all Sales personnel (Chi-square=9.42, p=0.01) and directors (Chi-Square=9.42, p=0.,01) with Cluster 2 in each case being the most likely to implement changes.

(6) Financial Requirements

Differences were noted in terms of further finance requirements (Chi-Square=4.65, p=0.09) with Cluster 3, the most acquisitive cluster, not surprisingly being the most likely to require further finance.

(7) Realisation

Significant differences were noted in exit intentions where the possibility of floating on the Stock Market produced a significant result (Chi-square=6.47, p=0.04) with all of Cluster 2 being prepared to consider this form of exit but none of Cluster 1, the grouping with the smallest size of company considering this option. While consideration of whether the buy-ins had actually exited produced a significance of only 0.17, the current status (receivership or restructured v successfully exited or still alive) produced a more significant but still marginal result (Chi-Square 4.86, p=0.09).

(8) The Target Company

When regrouped by size categories, the target companies showed significant difference in terms of size as measured by turnover (Chi-Square=11.12, p=0.03) with all of Cluster 1 having a turnover of less than £1 mn. While the two other clusters have similar average turnover, a higher percentage of Cluster 3 had a turnover greater than £5 mn.

While some areas of difference have been noted between clusters especially in aspects of managerial re-organisation and exit, the majority of post buy-in performance variables including those referring specifically to achievement of Plan objectives produced no evidence to suggest any distinct pattern of behaviour across clusters. A major reason for this may be the limited time span and the prevailing economic conditions which may affect the interpretation of performance data. In this light the emergence of buy-in realisation achievements which show significance levels of less than 0.10 may point to the development of longer term significant differences between clusters.

12.5 A Management Buy-out Team Leader Typology

The previous sections of this Chapter have determined a typology for Management Buy-in Team Leaders. Given the relationship between buy-outs and buy-ins, comparison was sought with Team

Leaders of management buy-outs to identify possible differences in the type of managers who considered buy-outs and buy-ins. (Potential differences are reviewed in Chapters 3.2). This process utilised the earlier survey of 1983-85 management buy-outs, described in Chapter 4.3 and used as a comparator in Chapters 6 to 10. While the survey used similar methods to that of the buy-in survey (see Chapter 4.3), inevitably, as the questionnaire had not been designed with the same research aims as the buy-in survey, this earlier survey did not cover all the motivational and background characteristics contained in the later buy-in survey. Indeed, given the expected differences between buy-outs and buy-ins outlined in Chapter 3, this is not surprising. Despite the differences in survey design, some valid comparisons are possible.

The buy-out survey covered basic motivational patterns such as desire to control one's own business, be free of Group restraints, seek financial reward, develop one's own talents, and having faith in the company as well as more defensive issues such as fear of redundancy or of a new owner. There was also considerable basic demographic background such as the age of individual members of the Team and their period of employment with the company, the type of vendor of the company and the initiator of the buy-out. Questions in the management buy-in survey included motivational questions on desire to do own kind of work, develop own strategy and avoid working for others which can be seen as having similarities with questions in the buy-out survey covering the motivation to control one's own business and develop own strategy. Financial rewards in the buy-out survey were covered in the buy-in survey by questions concerning capital gain and higher income considerations. The buy-in survey asked the importance of redundancy while the buy-out one covered fears of both redundancy and a new owner. Buy-out managers were also asked about the long term faith which they had in the company.

Variables suitable for use in the buy-out factor analysis were selected in an identical way to those in the management buy-in analysis. First all the purely motivational factors were included. Second variables were sought from other areas of the survey which might add to an understanding of the

entrepreneurial nature and other experience of the managers. Thus both the Team Leader's age and his period of managerial experience in this role were included (providing a direct equivalence to age in the buy-in typology and partial equivalence to managerial experience and entrepreneurial experience), a variable reflecting the source of initiation of the transaction (reflecting the role of management in actually initiating the transaction, an act which can be seen as entrepreneurial itself, eg Green and Berry 1991) and the type of company ownership. This last variable was selected in that it could be hypothesised that the degree of managerial and entrepreneurial initiative allowed in companies may vary depending on the type of ownership and the restrictions placed by the owners on executive managers, eg companies in the public sector will attract managers who work under control and initiative restrictions which are very different from those facing managers in a quoted company subsidiary.

As with the management buy-in survey, the motivational variables were tested for reliability using Cronbach's Alpha method. This produced an Alpha of 0.709 and Standardised Item Alpha of 0.696. The direction of the motivational variables were re-coded to make them consistent with those of the buy-in managers. The initiative and type of company variables were recoded to produce consistent interval data.

Through methods similar to those outlined in the factor analysis of management buy-ins, this series of motivational and entrepreneurial associated variables were subjected to factor analysis through a principal components analysis. The Bartlett Test of Sphericity (160.39) produced a significance level of 0.000. The Kaiser-Meyer-Olkin measure of sampling adequacy was 0.55. Five factors with Eigenvalues in excess of 1 were produced after the Oblimim had converged in 85 iterations, and explained 62.8 percent of the total variance (Table 12.6). These however were less satisfactory statistically than the buy-in factors, where 69.2 percent of the total variance was explained at this stage. An interpretation was then made of the five factors produced.

TABLE 12.6: MANAGEMENT BUY-OUT CHARACTERISTICS - FACTOR ANALYSIS					
	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5
Type of company	.86382				
Develop own talents	.30779	-.30551			
Years of experience		.86538			
CEO's Age		.83090			
Fear of new owner			.85550		
Rear of redundancy			.61209	.46620	
Failure company				-.79257	
Initiator	.46429			.46557	
Free of group restraints					.85885
Financial rewards	.32160				-.54106
Control own business				-.38913	.45509
Eigen value	1.92163	1.50507	1.28673	1.19289	1.00098
Variance (%)	17.5	13.7	11.7	10.8	9.1
Cumulative variance (%)	17.5	31.2	42.8	53.7	62.8

Factor 1, the largest group accounting for 17.5 percent of the variance, produced high positive loadings on the type of company, developing own talents, management as initiator and financial rewards. There was little evidence of fear of redundancy or of a new owner. This factor could be seen to reflect 'Personal and Commercial Ambition'.

Factor 2, showed high loadings for age and length of experience of the Team Leader but with developing own talents being very unimportant. The type of company in which the team was working had moderate importance. This could be interpreted as an 'Experience' factor.

Factor 3 was dominated by the fear of redundancy and of a new owner with negative factor score coefficients for controlling own business, being free of group restraints and initiative. It appeared to represent a forcing into buy-outs and could be seen to be a defensive 'push' factor.

Factor 4 had qualities which indicated a more pro-active version of Factor 3. Fear of redundancy (though not of a new owner) were important while initiative was more likely to come from the management. Age and length of service with the company were unimportant while the team placed emphasis on being free of group restraints. There was a high negative factor score coefficient in faith in the company. This Factor could be interpreted as a less defensive 'push' factor.

Finally Factor 5 reflected a desire to be free of group restraints, control one's own business and to seek financial reward. Negative aspects of motivation such as fear of redundancy or a new owner were not in evidence. The Team Leaders were likely to have had some relative experience. This factor could be interpreted as 'Opportunist'.

TABLE 12.7: MBO CLUSTER CHARACTERISTICS					
	Cluster 1	Cluster 2	Cluster 3	Anova F-test (sig)	Differences between clusters, 2 sample T-test
Factor 1	-0.18	0.69	0.53	.000	1,2 1,3
Factor 2	0.22	-1.52	0.20	.000	1,2 2,3
Factor 3	-0.26	-0.25	2.24	.000	2,3 1,3
Factor 4	-0.15	1.17	-0.27	.000	1,2 2,3
Factor 5	0.02	0.05	-0.23	.594	-
Number	136	22	18		
%	77.3	12.5	10.2		

The standardised matrix of component scores which were produced under this procedure were then subject to a cluster analysis to identify particular types of management buy-out Team Leaders using the same method as employed in the buy-in analysis, iterative partitioning. The characteristics of the individual clusters produced are outlined in Table 12.7. The number of buy-out manager types was reduced to three. Differences between mean scores across the cluster are indicated in the table based on the F-statistic from a one-way analysis of variance and a series of individual two sample T-tests and confirm significant differences between the clusters. Only Factor 5 ('Opportunist') show no differences across the clusters. Analysis by Cluster of the means of the variables is shown in Table 12.8.

TABLE 12.8: CLUSTER CHARACTERISTICS - MANAGEMENT BUY-OUTS					
Variable	global	standard deviation	cluster 1	cluster 2	cluster 3
Control own Business	5.772	1.86	5.7279	6.2273	5.5556
Free of Group Restraints	3.1705	2.10	3.3088	2.5000	2.9444
Financial Rewards	4.1761	2.12	3.9853	4.7273	4.9444
Fear of Redundancy	2.0227	1.78	1.6618	2.8182	3.7778*
Fear of New Owner	1.8409	1.68	1.4412	1.1364	5.7222*
Faith in Company	4.9943	2.20	5.1544	3.5000*	5.6111
Develop own Talents	3.5000	2.20	3.3088	3.9091	4.4444
Team as Initiator	1.9716	0.81	1.8309	3.0455*	1.7222
Team Leader's Age	3.3864	1.12	3.5809	1.8636*	3.7778
Team Leader's Experience	2.4545	1.31	2.6838	1.0000*	2.5000
Type of Company	3.4525	1.11	3.3588	3.8636	4.0556*

* Varies by more than half of the standard deviation from the global mean.

Cluster 1, by far the largest grouping accounting for 77.3 percent of the sample, was dominated by the 'Experience' factor with other factors being of relatively little importance. Given the dominant size of this grouping they were close to global means for a number of variables. They were slightly less driven by the needed to be rid of group restraints or to seek better financial rewards and did not appear to be afraid of either redundancy or a new owner. They tended to

be slightly older and had been with the company for a little longer. They had similarities to 'craftsmen' type entrepreneurs.

Cluster 2, the next largest grouping, involved Team where push factors were important but this was also accompanied by a relatively high level of personal and commercial ambition. The push factor was driven by fear of redundancy rather than of a new owner. They were keen to seek better financial results, develop their own talents and had the highest mean for wanting to control their own business. They were also substantially younger and with less experience of the company than other Clusters. They were also more likely to have initiated the buy-out with assistance from outside. Without the push factors they could have been labelled as 'opportunist'.

Cluster 3, the smallest grouping, was dominated by the defensive push factor (both the fear of redundancy and of a new owner) although there was also some evidence of an older management team also possessing some commercial and personal ambition. Like Cluster 2 they were keen to seek financial reward. Unlike Cluster 2 they had significant long term faith in the company. This Cluster can be best described as 'push'.

TABLE 12.9: SIZE OF MBO CLUSTER FIRMS

Variable	Global Mean	Cluster 1	Cluster 2	Cluster 3
Employees (number)				
• at time of survey	246.6	250.7	119.1	365.4
• pre buy-out	257.8	251.8	106.0	480.1
Price paid (£'000)	5,333	4,535	500	29,667

Examination was then made of the size of the company (Table 12.9). Cluster 2, those having basically opportunist characteristics although with a significant level of 'push' factors were

associated with the smallest companies in terms of both employment numbers and the value of the transaction. Cluster 3, the 'push' Team Leaders, was associated with very large buy-outs.

Significant differences were then sought between the various grouping over a number of variables which were seen as being similar to the those used in 12.4 for assessing variations between buy-in Team Leader types. Cross tabulation of individual variables with the clusters was carried out, testing for significant differences through Chi-Square tests. The results of areas where interesting levels of significance were found are shown in Table 12.10 which also illustrates the main areas of difference between the Clusters in these variables.

(1) Performance

The most important area of difference which required to be examined was performance in terms of profit and sales turnover compared with both the buy-out Plan and the actual before buy-out. For all four measures of performance the null hypothesis of no difference between the clusters was not rejected. However in terms of profit compared to forecast the differences across clusters were significant at the 7 percent level (Chi-Square=8.75, p=0.07). Cluster 2 performed notably worse than the others while Cluster 3 had the best level of achievement compared to the Business Plan.

(2) Deal Structuring

Differences were sought between clusters in terms of structuring the transaction and the use of particular financing instruments and types of institutions. Differences which were observed were outside the 0.1 significance level, the most important being in terms of the use of merchant banks, venture capitalists, enterprise and development agencies and CCRPPO shares.

TABLE 12.10: AREAS OF SIGNIFICANT DIFFERENCE BETWEEN MANAGEMENT BUY-OUT CLUSTERS			
VARIABLE	CHI-SQUARE	SIGNIF-ICANCE	COMMENT
PERFORMANCE			
Profit Compared to Forecast	8.75	0.07	C1 54.3% better, C2 28.6%, C3 70.6%
Profit Compared to Actual pre-mbo	0.95	0.92	C1 69.0% better, C2 72.2% better, C3 58.8% better
Sales Compared to Forecast	2.49	0.65	C1 48.4% better, C2 33.3% better, C3 47.1% better
Sales Compared to Actual pre-mbo	3.72	0.45	C1 56.9% better, C2 77.7% better, C3 70.5% better
STRUCTURING			
Use of Merchant bank	4.08	0.13	C2 4.8 %, C3 29.4 %
Use of Venture Capitalist	3.59	0.17	C3 52.9%, C2 83 %
Use of Enterprise and Development Agencies	3.73	0.15	C2 nil; C3 17.6 %
Use of CCRPPO shares	3.65	0.16	C1 35.2%, C2 26.3%, C3 56.3%
CONTROL MECHANISMS			
Purchase other services	10.68	0.00	C2 22.7%, C3 nil
Change of Auditor	3.84	0.15	None in C3
APPROACHES TO INSTITUTIONS			
Get best terms	6.77	0.03	C2 20%, C1 51.1%
Initial Rejection	5.51	0.06	C1 11.9%, C2 30%
MANAGEMENT			
Years of Experience of Finance Director	15.64	0.11	C1 older, C2 youngest
Recruitment of Senior Specialists	4.03	0.14	C1 27.9%, C3 11.1%
SUPPLIER/CUSTOMER			
Relationship with customers	6.83	0.15	C1 63.7% better, C3 38.9% better
Customers Lost	5.28	0.07	C3 22.2%, C2 nil
FINANCIAL ACTIONS			
Post-mbo cash flow problems	4.62	0.09	C2 35.6 %, C2 42.9%, C3 11.8%

Note: C1=Cluster 1; C2=Cluster 2; C3=Cluster 3

(3) Control Mechanisms

Few differences were noted in the conditions imposed by the financiers other than requirement to purchase other services (Chi-square= 10.68, p= 0.00).

(4) Approaches for Finance

Differences were however noted in the cases of managers approaching more than one institution. This had been done to try to get better terms (Chi-square= 6.77, p=0.03) with over half of Cluster 1 doing so and because of initial rejection (Chi-square=5.51, p=0.06).

(5) Management

No significant differences were noted between clusters in subsequent managerial changes.

(6) Supplier/Customer Relationships

Differences were however noted in customer relationships with Cluster 3 being the most likely to lose customers (Chi-square=5.28, p=0.07) while C1 were the buy-outs most likely to improve relationships with customers (Chi-square 6.83, p=0.15).

(7) Financial Actions

In terms of post buy-out financial problems, Cluster 3 were the least likely to suffer cash flow problems (Chi-square=4.62, p=0.09) and C2 the most likely.

Despite the presence of those differences the majority of variables did not show significant differences across clusters implying that buy-outs actions may be seen to depend on individual circumstances rather than broad groupings of buy-out managers.

12.6 Differences Between the Buy-out and Buy-in Clusters

Both the factor and cluster analysis of management buy-outs and buy-ins produced three clusters which had broad similarities in types of the descriptions which could be given to them-opportunist, craftsmen and push. However, the relative positions of these were different, the most important for buy-ins being opportunist (67.8 %) while buy-outs were dominated by 'craftsmen' (77.3%). In both cases the smallest grouping were 'push' although they accounted for a larger

proportion in buy-outs. The two typologies therefore suggest that the types of Team Leaders in buy-outs and buy-ins are intrinsically different, as hypothesised in Chapters 7 and 8.

The nature of the 'push' cluster appeared to differ between buy-outs and buy-ins in terms of the target companies (see Tables 12.4 and 12.10). While the 'push' buy-in Team Leaders were targeting the smallest of companies in terms of average employment, turnover and price paid, the 'push' management buy-out Team Leaders were in the largest companies. The 'push' buy-in Team Leaders may well not be sufficiently attractive to venture capitalists to back in larger transactions while the 'push' buy-out Team Leaders may be associated with larger defensive buy-outs, sometimes in the public sector, in this period which, despite a high price, may actually have been bought at an attractive price in terms of earnings potential and discount to net asset value.

Buy-out 'Opportunists' were also looking for companies which were considerably smaller than those sought by 'Craftsmen' while in the case of buy-ins size differences were marginal.

Both typologies showed few significant differences between their respective clusters for variables concerning the Team, control mechanisms, management actions, Team re-organisation, financial requirements and realisation objectives. Comparison between the attributes and actions of for example buy-out and buy-in 'craftsmen' is made more difficult by questions in the two surveys not being identical. However certain comparisons can be made.

Significant differences were not found in the performance measures between clusters for both buy-outs and buy-ins, although in the case of buy-outs profit compared to forecast was significant at the $p=0.07$ level. Buy-in opportunists were the most successful in bettering their profits plan although buy-out 'opportunists' were the worst. However buy-out 'opportunists' were the most successful at improving profits compared to the actual before. Similarly with turnover buy-in

'opportunists' were best at improving turnover compared to budget whereas buy-out 'opportunists' were best compared with actual before the buy-out.

Structuring and investor control mechanism produced some differences within buy-outs and buy-ins but there was no communality of areas where significant differences existed. Significant differences were noted for buy-out clusters in approaches to institutions, and customer relationships and management re-organisation which were not repeated in buy-in clusters. Some differences arose in buy-in exit intentions and actual method of exit which were not repeated in buy-out clusters.

The most interesting area of difference appears to be in post transaction finance. Differences between clusters at the p=0.09 level were noted in buy-in requirements for further finance and at the same level for buy-out cash flow problems. 63.2 percent of buy-in 'opportunists', the largest of the three clusters, had required further finance while the buy-out grouping most likely to experience post buy-out cash flow problems was the 'opportunist' cluster. It should be noted that the buy-in 'opportunists' were also most likely to engage in subsequent acquisitions, which would involve further finance.

12.7 Conclusions

The use of Factor and Cluster Analysis has enabled respondents to both the Buy-in survey and an earlier Buy-out survey to be reduced to three respective groupings of entrepreneurs reflecting motivational and basic personal dimensions. The Groups additionally have close resemblances with standard concepts of entrepreneurs identified in earlier studies of entrepreneurship- 'craftsmen' and 'opportunist'. For buy-ins, 'opportunists', 'craftsmen' and a 'push' cluster could be identified. For buy-outs, groupings were 'craftsmen', 'opportunist'/'push' and 'push'. However the distribution of Team Leaders between the three groups appear very different between buy-outs and buy-ins, the former having a much higher proportion of 'craftsmen' and 'push' related Team Leaders than

buy-ins. Given the high degrees of initiative and general pro-active behaviour in establishing a buy-in, this is not unexpected. In the case of buy-ins this 'push' cluster was very small, representing only three cases.

A search for significant variations across clusters produced only limited results with neither the buy-in nor buy-out clusters showing significant differences in terms of two basic aspects of performance- improvement in operating profit and in turnover compared to original plans. However a series of differences were noted in certain aspects of structuring the transaction, management action post transaction, senior management turnover, control mechanisms and exit intentions. Differences noted in buy-in clusters were not necessarily repeated in buy-out clusters.

Lack of differences may be partially attributable to the timing of the survey. Although the actual completion of the buy-outs and buy-ins did not take place in recessionary conditions, the survey itself was carried out at a point in the case of buy-ins when the economy was going into recession but for buy-outs when significant economic growth had started: consequently factors governing structuring and management action may be different. Additionally buy-outs in the 1983-85 period did not suffer from the over-pricing and over-leveraging which affected both buy-outs and buy-ins in the latter 1980's (see eg Bleackley and Hay, 1992). Nevertheless despite the identification of certain areas where significant differences across clusters were identified, the majority of variables did not show significant difference.

Another timing aspect was that many of the action and performance areas represented only a comparatively short period from the buy-in or buy-out completion and more significant results may have been obtained had a longer time frame been possible. It is interesting to note that the relationship of profit compared to plan for buy-outs was coming close to the $p=0.05$ level for buy-outs, where there was a larger proportion of companies with a longer period of post completion

trading than in the buy-in sample. For buy-ins a level of p=0.09 was achieved for realisation status at a point two years after completion of the survey.

The lack of differences between clusters in both the buy-out and buy-in surveys and important measures of performance is not unique. Similar outcomes were reported in a study by Roure and Keeley (1990) who noted that individual's characteristics, although no doubt important, were not statistically related to performance in new technology based ventures although team characteristics were. In the case of buy-outs and buy-ins, Team Leaders and members of the Team will have undergone extensive screening prior to receiving financial support from venture capitalists and banks; this will have been intended to eliminate potential under-performers. MacMillan et al (1987) have noted the strong dependence on the personality and experience of the entrepreneur. Timmons (1989, p 6) notes that the screening process results in very different performance results for venture capital backed ventures from new ventures in general. Storey (1982 p 120) saw the personal characteristics of the entrepreneurs exerting only the mildest influence on the subsequent performance of the firm. Stuart and Abetti (1990) found that the craftsman-opportunist orientation of the entrepreneur was only an extremely weak (p=0.21) influence on performance and that it was less of a determinant of success than other factors such as entrepreneurial experience. Westhead (1990) did not find significant differences between his six Welsh founder type clusters in terms of profitability or revenues. Lafuente and Salas (1989) could only find differences between four Spanish entrepreneurial cluster types in terms of sales growth and profitability at the 15 percent level. Begley and Boyd (1987) found little relationship between psychological attributes and financial performance between entrepreneurs and small business managers.

The Proposition P9 cited in Chapter 3.3 that buy-in Team Leaders are mainly opportunistic but with a minority of craftsmen can be confirmed with the proviso that 'push' factors, originally seen as unlikely, did occur to a small extent. It can be confirmed that buy-out managers can be are less opportunist and more likely to be influenced by 'push' factors.

CHAPTER 13

BUY-IN PERFORMANCE PREDICTION

13.1 Introduction

Chapter 12 has shown that while the clusters produced from a factor analysis of motivational and other entrepreneurial variables can identify specific types of Team Leaders significant differences did not emerge in terms of operating performance between these three types of Buy-in Team Leaders. This may be attributable to the serious problems which emerged in the UK economy between buy-in completion and the time of the survey (causing corporate distress which may have distorted normal measures of comparative performance) and the effects of the venture capital screening process. Additionally the question on which this analysis was based relied on a general direction effect rather than actual accounting data. The results however had similarities with other studies of entrepreneurial cluster types (eg Westhead 1990, Lafuente and Salas 1989).

Consequently performance may be determined possibly by a broader set of factors than just the type of entrepreneur. For instance the importance of product and market assumptions in Business Plans have been noted by Dubini (1989) and MacMillan et al (1987), the completeness of the founding team, technical superiority of the product, buyer concentration and product development time by Roure and Keeley (1990) and the actual entrepreneurial experience of the leader by Stuart and Abetti (1990) and Vesper (1980). Hofer and Sandberg (1987) cite three factors as having a substantial impact on new venture performance- the structure of the industry entered, business strategy used by the new venture and the behavioural characteristics of the founding entrepreneurs. In determining high growth from low growth ventures Siegel et al (1993) noted the key role of experience in a similar industry.

A series of possible influences on the performance of the sample which had been discussed in the literature survey was re-examined. Relevant aspects described in Chapter 2.3 include educational

and managerial backgrounds of the Team Leader, his age, the relationship of the incubator to the new venture and the management's knowledge of the target, attitude to risk, previous entrepreneurial experience and the presence of skills gaps. Chapter 2.6 in reviewing performance and life cycle aspects referred to the incentives of equity ratchets, the bonding effect of high levels of debt and the control and monitoring functions of venture capitalists. Size and the need for turnaround (Chapter 2.2.6 and 2.6.3) have also been seen to be relevant in assessing the performance of buy-ins.

Chapter 13 widens the investigation into the features of initial buy-in performance to identify if more general entrepreneurial characteristics as well as target company demographics have an influence beyond the cluster types identified in Chapter 12.

13.2 The Use of Discriminant Analysis

The extension of the previous Chapter's investigation into buy-in performance involves first the identification of entrepreneurship, corporate restructuring and company specific variables which may have an impact on subsequent performance of the buy-in, followed by the use of discriminant analysis to identify which ones of the hypothesised variables are important. Alternative models are used to find the most effective.

Discriminant analysis classifies cases into one of several mutually exclusive groups on the basis of various characteristics and establishes which of these are important for distinguishing among the groups. It also evaluates the accuracy of the classification. Linear combinations of the independent, 'predictor' variables are formed and serve as the basis for classifying cases into one of the groups (Norusis, 1985). The coefficients for the linear combinations are so chosen that they result in the 'best' separation between groups. Accuracy is assessed by applying the model to cases for whom group membership is known and comparing actual group membership to predicted. While each group must be a sample from a multivariate normal population the function has been

shown to be fairly robust in a variety of other situations. Consequently certain dichotomous variables, which could not be used in the earlier factor analysis (Chapter 12.2), can be re-introduced.

Alternative approaches for the determination of a suitable dependent performance variable which could discriminate between unsuccessful and more successful cases were sought and two main possibilities identified- the existence of financial distress in the target company (as measured by buy-ins which had failed or been refinanced v those that had not) and the direction of operating profit compared to the Business Plan. It was noted that models which are used to predict failure may be flawed because of the low probability of failure, high classification accuracy obscuring the situation that in ex ante terms the overwhelming majority of failure signals are given in respect to survivor companies (Piesse and Wood 1992). Consequently the method using profit trend was therefore utilised.

The operating profit trend variable gave respondents seven categories of percentage deviation of actual operating performance from the original buy-in Business Plan. The major limitations were that the relevant question was phrased in general terms, did not seek actual accounting figures and did not split the deviation from plan into specific time periods other than the overall time since the buy-in. It was, of course, difficult to obtain any more precise indicators given the relatively short time period after buy-in. The survey questionnaire did not examine the Business Plan performance relative to the actual being achieved before the buy-in. Given that the Plan in itself would be likely to reflect a significant improvement on earlier performance, the extent of improvement may be understated in this question. As discussed in Chapter 11.2 the use of this measure of performance has certain limitations, notably the varying periods being covered, the unusual economic and financial conditions at the time of the survey, the use of financial as opposed to other types of operating performance and the non-use of accounting data.

The operating profit variable was then re-coded to produce two groupings- those companies which were performing worse than Plan and those better. The relatively small sample size meant that statistical validity assumptions could not be met using more than two groupings.

Further to the description of variables outlined in the Introduction a selection of independent variables relevant to the entrepreneurial characteristics involved, corporate restructuring and company specific areas and which were felt to be relevant to the overall performance of the target company was made (see Chapters 3.7). The predictors were variables which could be determined at the time of buy-in rather than events happening subsequently.

Variables selected to test for entrepreneurial related factors were: the Team Leader's entrepreneurial Experience; the Team Leader's experience of being in a management buy-out; the Team's knowledge of the target company; whether the Team had moved within the same sector; the Team Leader's managerial background; the Team Leader's educational background; the presence of Finance or Marketing skill gaps; the Team Leader's attitude to personal financial risk; the Team Leader's age; the regression factor scores 1 (Commercial Ambition), 2 (Independence), 3 (Investment), 4 (Practicality), 5 (Personal Ambition) and 6 (Pushed) (12.2).

Variables seen as reflecting the influence of corporate restructuring were: the use of equity ratchets and the size of the management equity share (to test equity incentive theory); gearing ratio (to test debt bonding effects); and board representation and the leading equity investor (3i v clearing bank development capital institution v other venture capitalist) to examine monitoring and control arguments.

Other variables reflecting deal specific and other effects were the source of the company, turnover and profit characteristics at the time of buy-in; and the year of buy-in. Where necessary variables were re-coded to put them on a more consistent basis.

Discriminant analysis represents an exploratory tool and it is not known in advance which of the selected variables are likely to be important for group separation and which are effectively extraneous. Clearly one of the desired end products of the analysis is identification of the good predictor variables (Norusis 1985). This process can be assisted through using a step-wise selection procedure. In this type of procedure the variables thought to be relevant are inserted in the model, the first of the list of variables selected is entered; this variable has the largest acceptable value for the selection criterion. After the first variable is entered, the value of the criterion is re-evaluated for all the variables not in the model and the variable with the next largest acceptable criterion entered next. At this point the variable entered first is re-evaluated to determine whether it meets the removal criterion. If it does, it is removed. Various criteria can be used in stepwise analysis. In this case the analysis was based on minimising the overall Wilks Lambda[1]. Under this method at each step the variable which results in the smallest Wilks Lambda for the discriminant function is selected for entry.

As described earlier certain assumptions must be met for discriminant analysis to prove satisfactory. Certain dichotomous variables were included in the selection. Although the linear discriminant function requires that the predictor variables have a multivariate normal distribution, the function has been shown to perform fairly well in a variety of other situations and the robustness of the technique suggest its use in this application (Norusis 1985). The group covariance matrices were checked for equality using Box's M test and a linear discriminant function was deemed to be most appropriate. While discriminant analysis does allow the use of prior probabilities, it was felt that given the relatively small sample numbers and the subjective nature of such a policy it would not be appropriate.

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[1] As an alternative method and a check to the Wilks Lambda stepwise selection method, the same variables were also run using a stepwise analysis based on two other methods. The first maximised the value in Rao's V. The second method maximised the Mahalanobis' distance between two closest groups. Both produced similar results to the Wilks Lambda minimising method.

Four basic models were used in the analysis:

(a) All of the variables reflecting entrepreneurial characteristics of the Team Leader and aspects of the target company and deal structuring but excluding variables derived from the factor analysis;

(b) All the variables in the first but also including the factor regression variables which had been calculated in the determination of the entrepreneurial typology (Chapter 12.2);

(c) The factor regression variables themselves; and

(d) The factor regression variables but not using a step-wise reduction procedure.

13.3 The Results

Before carrying out the discriminant functions, the means of the variables were determined to show overall directional patterns which might exist (Table 13.1). These indicated that buy-ins which had performed better than Plan could be associated with: an earlier year for the buy-in; a lower level of educational background of the Team Leader; the absence of a finance skills gap; lower personal financial gearing; more entrepreneurial experience of the Team Leader; more knowledge of the target company; a higher level of profitability at the time of buy-in; older Team Leaders; lower levels of educational achievement; the target not having been a privately owned company; a lower incidence of ratchets; board representation by venture capitalists; no experience of having been in a previous buy-out; and a lower share of equity by the management team. The results of the four models in terms of the canonical discriminant function coefficients and the grouped cases correctly classified are shown in Tables 13.2 and 13.3 respectively. Model 1, using the entrepreneurial and company variables but excluding the factor regression variables,

successfully predicted 84.6 percent of group membership with an eigenvalue of 0.90[2]. It had reached its conclusion in ten steps. The sequence of inclusion of variables was the Team Leader's financial resources, source of the company, Team Leader's previous experience of being in a management buy-out, the Team Leader's education, team knowing each other before, the

TABLE 13.1: MEANS OF DISCRIMINANT VARIABLES*				
VARIABLE	GLOBAL MEAN	WORSE THAN FORECAST	BETTER THAN FORECAST	TOTAL CASES
Size (Turnover)	1.96	2.00	1.92	55
Equity Institution	1.65	1.69	1.62	55
Buy-in Year	3.13	3.24	3.00	55
Same Sector	0.60	0.62	0.58	55
Team Leader's Background	1.67	1.67	1.68	52
Team Leader's Education	1.82	1.66	2.00	55
Finance Skills Gap	0.29	0.31	0.27	55
Marketing Skills Gap	0.20	0.17	0.23	55
Team Leader's Finance	3.38	3.69	3.04	55
Team Leader's Entrepreneurial Experience	0.29	0.28	0.31	55
Knowledge of Company	0.89	0.83	0.96	55
Size of Profits (pre-MBI)	1.93	1.91	1.96	55
Gearing ratio	2.33	2.38	2.27	55
Team Leader's Age	2.81	2.72	2.92	54
Source of Company	2.53	2.66	2.38	55
Ratchet	0.38	0.41	0.35	55
Board representation	0.49	0.48	0.50	55
CEO in Previous MBO	0.11	0.17	0.04	55
Team % Equity	2.22	2.31	2.12	55
Factor1 (commercial ambition)	0.03	-0.18	0.26	52
Factor2 (independence)	-0.02	-0.01	-0.03	52
Factor3 (investment)	0.05	-0.07	0.18	52
Factor4 (practicality)	-0.05	0.07	-0.18	52
Factor5 (personal ambition)	-0.04	0.24	-0.33	52
Factor6 (pushed)	0.02	-0.10	0.14	52

* All Cases

[2] An Eigenvalue of more than 0.40 is considered excellent (Hedderson, 1987).

TABLE 13.2: CANONICAL DISCRIMINANT FUNCTION COEFFICIENTS		
Model 1:	Standardised	Unstandardised
Buy-in Year	0.39835	0.493810
Team Leader-Managerial background	-0.28819	-0.4040205
Team Leader- Education	-0.78773	-1.016953
Team Leader- Financial resources	0.40843	0.3148362
Team's knowledge of each other	-0.79443	-2.503676
Team Leader's Age	-0.39404	-0.3689661
Source of company	0.86743	1.077130
Use of equity ratchet	0.30601	0.6257191
Equity % held by Team	0.65952	0.7433415
Team Leader in previous MBO	0.37610	1.272552
Constant	-	-1.400332
Group centroid	(1) 0.89542 (2) -0.96706	
Eigenvalue=0.90056		
Model 2:		
Size- Turnover	0.29806	0.3588693
Buy-in year	-0.46306	-0.4991332
Team Leader-Managerial Background	0.24896	0.3490209
Team Leader- Education	0.91074	1.175760
Finance Skills Gap	0.44631	0.9498154
Team's knowledge of each other	0.95583	3.012354
Source of company	-0.84507	-1.049368
Use of Equity Ratchet	-0.55078	-1.126221
Equity % held by Team	-0.85165	-0.9598788
Commercial Ambition	0.48889	0.5070521
Personal Ambition	-0.62777	-0.6330574
Constant	-	0.3977453
Group Centroid	(1) -1.04120 (2) 1.12449	
Eigenvalue=1.21765		
Model 3:		
Commercial Ambition	0.58130	0.6029031
Investment	0.46315	0.4718267
Personal Ambition	-0.73161	-0.7377807
Pushed	0.38968	0.3595380
Constant	-	-0.7608743 (E-01)
Group centroid	(1) -0.42737 (2) 0.46156	
Eigenvalue=0.20515		

Model 4:		
Commercial Ambition	0.56580	0.5868203
Independence	0.11528	0.1133628
Investment	0.46758	0.4763343
Practicality	-0.25253	-0.2519688
Personal Ambition	-0.70806	-0.7140343
Pushed	0.36134	0.3333903
Constant	-	-0.8442897 (E-01)
Group centroid	(1) -0.44397 (2) 0.47949	
Eigenvalue=0.22140		

TABLE 13.3: DISCRIMINANT ANALYSIS: CLASSIFICATION RESULTS					
		Predicted Group Membership:			
	No of Cases	Group 1 No.	Group 1 %	Group 2 No.	Group 2 %
Model 1:					
Group 1 (Worse than budget)	27	22	81.5	5	18.5
Group 2 (Better than budget)	25	3	12.0	22	88.0
Ungrouped cases	4	1	25.0	3	75.0
Percent of grouped cases correctly classified = 84.62					
Model 2:					
Group 1 (Worse than budget)	27	26	96.3	1	3.7
Group 2 (Better than budget)	25	4	16.0	21	84.0
Ungrouped cases	4	1	25.0	3	75.0
Percent of grouped cases correctly classified = 90.38					
Model 3:					
Group 1 (Worse than budget)	27	15	55.6	12	44.4
Group 2 (Better than budget)	25	9	36.0	16	64.0
Ungrouped cases	4	3	75.0	1	25.0
Percent of grouped cases correctly classified = 59.62					
Model 4:					
Group 1 (Worse than budget)	27	16	59.3	11	40.7
Group 2 (Better than budget)	25	9	36.0	16	64.0
Ungrouped cases	4	3	75.0	1	25.0
Percent of grouped cases correctly classified = 61.54					

year of the buy-in, the share of equity held by the Team, the CEO's age, the CEO's type of managerial background and the use of an equity ratchet.

Examination of the group centroids showed that variables describing educational status, team knowledge of each other and to a lesser extent background managerial experience, and the Team Leader's age were associated with performance which was better than projected in the Business Plan. Interpreting these indicate that good performance (which had a negative group centroid) was associated with lower educational qualifications (rather than higher); previous personal knowledge of each other in the team; the Team Leader's specific managerial background; and older Team Leaders.

In contrast poor performance was associated with buying a private company (rather than a divestment from a quoted group); a high element of Team equity; a later year of buy-in; higher personal gearing by the Team Leader; the presence of a ratchet; and the Team Leader's experience of having been in a previous buy-out. Discussion and implication of these results follows after description of the results from the other models in 13.4.

Model 2, containing both the Factor Variables and the normal variables, produced the most accurate prediction rate. This model which had a 90.4 percent correct prediction rate and an even more satisfactory eigenvalue of 1.22 had reached its conclusion in eleven steps but had used only two of the Factor variables, 'Personal Ambition' and 'Commercial Ambition'. In this process the variables had been selected in the order of 'Personal Ambition', source, team knowing each other before the MBI, the Team Leader's education, the share of the equity held by the Team, the year of the buy-in, 'Commercial ambition', the presence of a ratchet, a finance skills gap, the size of the company in terms of turnover and the Team Leader's managerial background. Common to both Models 1 and 2 were source, team's knowledge of each other before the buy-out, the Team Leader's education, the team's share of the equity, the presence of an equity ratchet and the CEO's managerial background.

Examination of the discriminant function coefficients and the group centroids showed that performance better than Business Plan was associated with Commercial Ambition, the company's turnover, the managerial background of the Team Leader, his educational background, the presence of a Finance Skills gap and the team's knowledge of each other prior to the buy-in. Interpreting these would indicate that better performance was achieved where companies were larger, the Team Leader had specific management experience, was less highly educated, there was a finance skills gap (ie allowing a new approach to finance and control systems to be introduced), where there was personal knowledge of the team beforehand and where there was a high degree of commercial ambition (perhaps reflecting specific commercial opportunity). In contrast poor performance was again associated with the later buy-ins, those bought from a private rather than publicly owned source, those involving a management equity ratchet, where there was a high percentage of Team equity (likely to be in the smaller transactions) and where there was a high degree of Personal Ambition.

Model 3 using just the regression factor scores obtained in the initial factor analysis produced a less statistically acceptable result with an Eigen value of 0.21 and a classification result of 59.6 percent. Two of the regression factors, 2 (Independence") and 4 ('Practicality'), were not selected in the procedure. Again Personal Ambition had a negative relationship while Commercial Ambition, Investment and Push had a positive relationship to good performance.

Model 4 using all the Factor regression variables and not using a step wise procedure produced only a marginally better result, the Eigenvalue increasing to 0.22 and the percentage of group cases correctly classified to 61.5 percent. Factor Variable 5, 'Personal Ambition' had the highest standardised canonical discrimination function coefficients, again being associated with poor performance. Practicality was also associated with good performance.

13.4 Discussion and Conclusions

Discriminant analysis provides a useful indication of the relevant factors which may determine an outcome although it does not in itself deduce causality. This technique has been used in the Chapter to extend the conclusions in Chapter 12 that no major differences in performance could be seen across the entrepreneurial cluster types. The discriminant analysis confirmed that consideration of entrepreneurial typologies, especially those which are reliant on primarily motivational patterns alone (Models 3 and 4), do not act as satisfactory predictors of over or under performance by buy-ins.

In contrast the use of variables reflecting basic parameters of the target company, the structuring arrangements and specific demographic information on the Team Leaders produced a much better statistical indication of performance possibilities. Where this is supplemented by the 'Personal Ambition' and 'Commercial Ambition' entrepreneurial factors over 90 percent of the sample could be categorised into the correct profit direction classification. The first two Models shared many common characteristics with the group centroids in both cases showing considerable discrimination between non-achievers of the Business Plan and those that did. Thus buy-ins which showed satisfactory performance in both Models reflected the Team's knowledge of each other, lower educational status and to a small extent the Team Leader's specific managerial background. In contrast poor performance was correlated with the target being privately owned previously, a higher management equity share percentage, the later 1980's buy-ins and the presence of a ratchet.

Such results provide support for some of the theories outlined earlier in the Thesis although there are inconsistencies, some of which may be explainable. While the results do show some similarities to entrepreneurship research findings, they indicate that buy-ins, at least in the conditions at the end of the 1980s, work in a different way from what might be expected from earlier consideration of corporate restructuring.

The benefits from corporate restructuring are seen as coming from equity incentive effects, debt bonding and superior control and monitoring (Chapter 2.1 and 2.6). Consequently gearing, management equity shares, equity ratchets, the use of non-executive directors by the venture capitalists and the type of venture capitalist might have been expected to have had an important positive influence on performance. However this does not appear to have happened with some of the variables actually having a reverse effect. Buy-in gearing was not selected in the stepwise procedure indicating that high gearing was not a major determinant of operating profit direction. Personal financial gearing did emerge as an influence in Model 1 (but not Model 2) with higher personal reliance on loans reflected in Business Plan under achievement. Entrepreneurs may however be only moderate risk takers (eg Mancuso 1975).

The role of management equity incentives also does not appear to behave in the way indicated by corporate restructuring arguments. Expectations would be that higher equity percentages and incentives through equity ratchets would lead to better performance, whereas in this survey the reverse appears to have applied. Higher initial equity stakes and the presence of a ratchet were both associated with lower performance in each of Models 1 and 2. This is counter to the case of buy-outs which have subsequently floated (see Thompson, Wright, Robbie 1992) but may be related to two considerations. Ratchets may be imposed in cases where there are doubts in the venture capitalists' minds as to the feasibility of management projections being realised (Wright, Thompson, Chiplin, Robbie 1991, p 115) while high management equity percentages are likely to be associated with smaller deals (Chiplin, Wright, Robbie 1992) which themselves in Model 2 did show some (relatively weak) association with poor performance.

Control devices in the form of appointment of non-executive directors or difference in type of venture capitalist were not included in any of the steps. This lack of influence may reflect homogeneity of venture capital approaches. This may be caused for instance by the number of ex-3i employees working in other institutions and the role of professional advisers in working on deals subsequently financed by a variety of venture capitalists. This lack of difference however

supports MacMillan et al (1987) who noted that three different investment strategies identified as differentiating venture capitalist behaviour were about equally effective- the mean performance being similar for all three. Ruhnka and Young (1991) also believed that available empirical studies of risk perception of venture capital investors, interpreted in conjunction with psychological risk theory, are sufficient to suggest several common behaviours of venture capital investors towards some of the key risk and reward assessments in making investment decisions.

The presence of particular skills gaps also did not appear to be a determinant of performance, evidence on management change post buy-in implying that these were filled shortly after buy-in. In terms of entrepreneurial factors the extent of the Team Leader's previous entrepreneurial experience somewhat surprisingly also was not as significant as had been expected. Actual experience of an entrepreneurial venture, which studies such as Stuart and Abetti (1990) and Vesper (1980) show as having a significant effect on new venture performance, did not enter the step-wise selection procedure. Contrarily experience of participation in an earlier management buy-out produced a negative relationship with performance in Model 1. This may partially reflect the early stage of development of the market for second time entrepreneurs in the UK (Somerville 1993). Higher education was also negatively related to performance in both models. However entrepreneurship literature appears divided in this, some studies (eg Roubidoux and Garnier, 1973, Pickles and O'Farrell, 1986) showing a positive relationship of education with performance while others indicate a less strong or even negative relationship (eg Stuart and Abetti, 1990). While knowledge of the actual sector was not selected as an influence in the stepwise procedure, a key factor reflecting the stability of team formation (Timmons 1990) was whether members of the Team had known each other before hand. Under both models this variable produced a high correlation with good performance, appearing to have a stronger influence than whether the team remained within the same sector or not.

Among company specific factors the source of transaction- private company sale v plc divestment- produced important results, private sales showing a strong negative relationship to performance

in both models. This raises questions as to the ability of buy-ins to be successful as a corporate restructuring tool for private sales and whether it is more appropriate for larger subsidiaries of groups where information asymmetries during due diligence procedures may not be so important. Major size related differences did not emerge while previous loss-making characteristics did not appear to be determinants of early performance achievement.

To a large extent poor performance also appeared as a reflection of the economic and financial cycle, buy-ins taking place near the top of the cycle being less likely to succeed. The year of the buy-in proved to be an important variable, buy-ins in the 1988/89 period generally believed to suffer from the consequences of having paid excessive prices for the business (and consequently general over leverage applying) and the effects of later poor economic and financial conditions (Dunne 1993). This is supported by worries by Jensen (1991) and Kaplan and Stein (1990) as to the comparative stability of later US LBOs compared to those in the earlier 1980's and by Argenti (1976) as to the general effects on a company of a combination of high leverage and economic downturn.

In the case of management buy-ins the results of investigation into the importance of performance related variables must also be qualified by the distorting effects of problems of information asymmetry (Hutchings 1987) and the long period which may be required to achieve a turnaround (eg Zimmerman 1991) which may result in initial performance indicators being unreliable indicators of medium and long term profit direction.

Overall, discriminant analysis of buy-ins have failed to meet major areas of the performance proposition outlined in P17. Notably corporate restructuring variables reflecting a high level of Team equity ownership did not appear to be determinants of good performance, there was little influence of governance mechanisms (through type of venture capital firm) and debt bonding (as shown through gearing) did not appear to determine good performance (P17b). Indeed ratchets had a negative influence.

Among more entrepreneurship orientated variables, earlier personal knowledge of the Team appeared to be strong determinant of good performance (P17a) but contrary to the proposition entrepreneurs who had not achieved higher education achieved their plans better.

The importance of source of buy-outs was confirmed (P17c).

CHAPTER 14

MANAGEMENT BUY-IN CASE STUDIES

14.1 Introduction

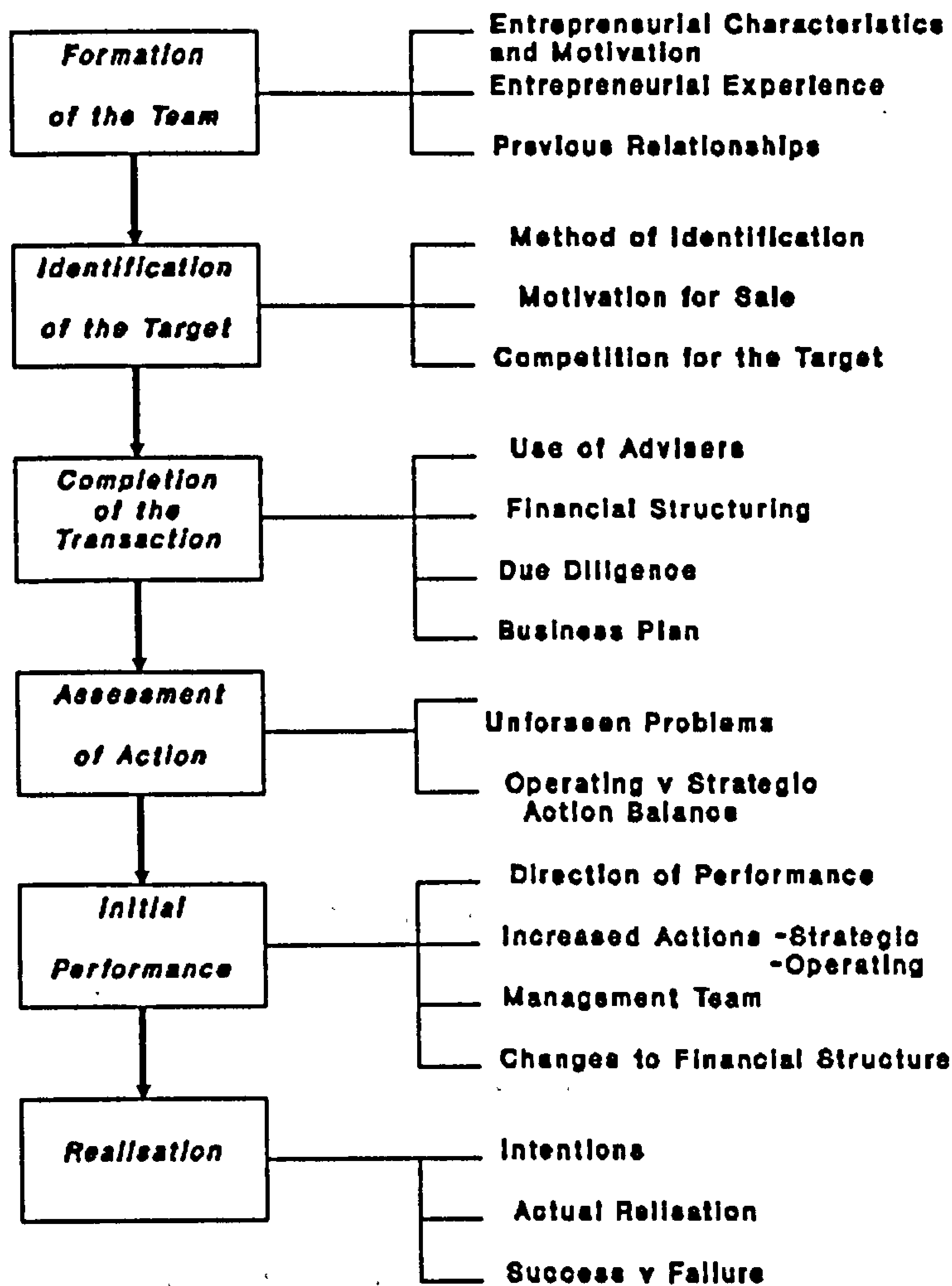
As outlined in Chapter 4.4, the quantitative data obtained through the questionnaire survey has been supplemented by a series of more in-depth case study interviews with Team Leaders. Such an approach was designed to provide a deeper insight into the management buy-in process, the backgrounds to the team, the weighting of problems which emerged, relationships with their venture capitalists and their longer term aims. Case studies were selected to represent a suitable cross section of private buy-in backgrounds with comparison made with James Neill, a buy-in more in the US LBO style rather than a UK private buy-in.

14.2 The Management Buy-in Process

For expositional purposes the analysis in the cases is structured to highlight the issues which arise in the buy-in process (Figure 14.1) and can be seen to refer to questions raised in Chapters 2 and 3. They cover the formation of the Team, identification of the target, the completion of the transaction, assessment of action, initial performance and realisation issues. The individual parts of the process incorporate issues raised in earlier chapters as follows:

(a) Formation of the Team: Questions arise concerning the entrepreneurial experience of the Team (Chapter 2.3.3), personal and managerial background (Chapter 2.3.2), the motivation of the Team (Chapter 2.3.4) and their previous relationships with each other and incubators (Chapter 2.4.2);

Figure 14.1
The Management Buy-in Process



(b) Identification of the target company. This section covers issues concerning the method of identification, including the role of formal and informal networks (Chapter 2.4.2), the vendor's motivation and reasons for selling the business and competition with other bidders (Chapters 2.3.3 and 2.3.4);

(c) The completion of the transaction. This includes the use of advisers, the deal negotiation and due diligence processes, the Business Plan and the selection of the venture capitalist (Chapter 2.4.4) and the financial structuring of the deal (Chapter 2.5.1) including governance issues (2.6.5);

(d) Assessment of post Buy-in action. This covers the types of action which were seen as initially necessary and the relative importance of operating and strategic actions (Chapter 2.6.3). It also refers to problems which may not have been identified during the due diligence process and which subsequently proved to be significant;

(e) Initial performance. This analyses the initial direction of the firm's performance (backed up by accounting data) in terms of profit, turnover and balance sheet variables (see Chapter 2.6.2) and examines the reasons behind variances with original intentions. This allows the impact of increased actions and in particular re-organisation of the management team to be assessed (Chapter 2.6.3, 2.6.4). Changes to the financial structuring of the company to account for variations in performance are examined;

(f) Realisation. The Team's original realisation intentions are examined together with changes to these intentions and analysis of any realisation which has actually been achieved (Chapters 2.6.6). Such exits may reflect success or failure of the buy-in.

The Cases, which are described in more detail in Appendix 7, have shown a wide diversity of backgrounds of both management and target companies and unlike other collections of buy-out case studies (eg Kreiger 1990, Clutterbuck and Devine 1987, Green and Berry 1991) have not been confined to successful transactions. The sixth case, James Neill, has been modelled on the more typical U.S. LBO style of transaction and presents an interesting contrast with the other cases.

14.3 Formation of the Buy-in Team

In the formation of the Team issues arise concerning the personal demographic backgrounds of the individual members, their previous relationship, evidence of entrepreneurial experience and the type of entrepreneur which the Team Leader appears to be.

There was considerable variation between the buy-ins in terms of the relative size of buy-in teams. The two largest case studies, European Brands and James Neill, both had five members although in the former two of them were clearly the motivators and very much key. In contrast, The Maids, had three team members in a company one thirtieth the turnover of European Brands and Slingsby four with one third of the turnover. Larger teams in small companies may present problems in terms of cohesiveness and cost base; it is interesting to note the particular problems referred to in Annexe 7 concerning the subsequent break-up of the Slingsby team. Whether the teams had worked together was seen by all Team Leaders as to be very important, giving an indication of both the personal and business strengths and weaknesses of individual team members.

Previous working relationships may of course not prove to be a good indicator of future performance but were expected by Team Leaders to be a better indicator than involving new partners at the start of the buy-in process. Indeed the Team Leader of The Maids felt that the strength of the Team was more important than the strength of the acquisition. The Maids Team had worked together as a nucleus for three years, knew each other's strengths and weaknesses (Both business and personal) and were able to bring themselves through the initial problems of the buy-in. There was some variation between the Teams as to how closely and recent the working relationship had been. In the three smaller buy-ins the working relationship had been current at the time of planning the buy-in whereas in the cases of Metalliform it had been a more remote relationship and in European Brands the key relationship within the Team had reflected an earlier involvement. In the sixth case, James Neill, the majority of the team had several years of working together as well as during a very concentrated search period which created a very cohesive team. While differences could be seen in subsequent team relationships, there was no evidence to suggest that those with looser relationships were in fact less likely to succeed than those with current experience and mistakes had been made in team selection among those who were working together immediately pre buy-in.

TABLE 14.1: CASE STUDIES COMPARED

	The Maids	AGK	Slingsby	Metalliform	European Brands	James Neill
Team Formation:						
• Composition	Three	Three	Four	Two	Five	Five
• Previous Relationship	Worked together	Worked together	Worked together	Group relationship	Worked together to varying degrees	Worked together on acquisition
• Entrepreneurial Cluster	Opportunist	Craftsman	Craftsman	Opportunist	Opportunist	n/a
• Entrepreneurial Experience	None	Failed buy-out attempt	None	None	Strong	Yes
• Management Experience	General, Financial	General	General	General, Sales, Finance/Admin	General, sales	General
• Skills Gap	No	Financial	Financial	Finance	Finance	No
• Education	Professional qualifications	University	University	? University	University	University, No.2-MBA
• Age	26-35	41-55	41-45	41-45	41-45	46-55
• Parental Background	Professional	Professional	Professional	Professional	Professional	Skilled
• Previous Employer	Top 500	Private	Private	Top 500	Top 500	Overseas Company

Target Company:						
• Method of Identification	Earlier take-over analysis	Personal knowledge as competitor	Industrial contact	Group company	Financial institution	Sophisticated company research
• Vendor Motivation	Poor prospects, lack of profitability	Cash requirements, poor profits	Next generation not interested	Redefinition core activities, finance requirement	Poorly performing MBO with no other exit option	Poor results and hope for independence for company
• Type of Company	Private	Overseas controlled	Private	Plc	MBO	Quoted/Going private
• Competition for Target	None	Yes	None	Yes	Yes	Non hostile
• Turnover	£500k	£4.7m	£4.7m	£16.2m	£15m	£80m
• Operating Profit	(£75k)	£0.4m	£400k	£400k	£2m	£7.7m
• Deal Value	£303k	£2.571m	£964k	£3.7m	£17.4m	£77.8m
• Characteristics	Stable cash flow, stable demand, growing industry, no import competition	Highly positive cash flow, low import exposure, reasonable industry growth	Significant cash requirements, low import competition, stable industry demand	Reasonably positive cash flow	Moderately declining size of industry	Very stable technology, stable demand, reasonable cash requirements

Transaction Completion:						
• Date of Completion	10/1989	7/1989	8/1987	6/1989	7/1988	10/1989
• Due Diligence	Inadequate a/c info	Inadequate a/c info	No obvious problems	No problems at time as prior operating knowledge	Warning signals	Extensive, subject to constraints of public take-over
• Selection of Financier	3i as main local source	Use of earlier potential mbo financier	Beauty parade	12 institutions approached	Institution contact	LBO association
• Financial Structuring						
-Management share	75%	60%	60%	65%	n/a	100% (Partnership Fund)
-Management contribution	£150k	£75k	£68K	£100k	£1.82m	£58.1m
-Ratchet	No	Yes, 60-65%	Yes, down to 51%	Yes, 49% to 75%	Yes	n/a
-Gearing	1.3	20.5	2.6	2.9	1.6	1031(1.8)
• Presence of Non-Executive Director	None	One	One	One	Two	Two
Assessment of Action:						
• Unforeseen Problems	Yes, poor state franchise network, previous flawed audit	Slow award contracts, serious decline profitability during negotiations, collapse plant hire, asset valuation	Run down of business during negotiations, wrong and over-age stock mix	Changes in local govt purchasing system (raised but evaded in due diligence)	Inadequate warranties	No
• Balance Operating & Strategic Action	Higher operating emphasis than planned	Serious operating actions but need to have high level strategic action to gain turnover	High initial reliance on cost reduction	Well defined strategic and operating programme	Balance on strategic, but operating required to some extent	Comprehensive plan with good balance

Initial Performance:						
• Direction	Marginally better	Significant shortfall	Failure to achieve	Marginally better year 1, but collapse year 2	Worse than target, followed by failure to get benefits from acquisitions	Marginal undershoot year 1
• Breadth of Actions	Wide	Very wide	Wide	Very wide	Wide/comprehensive	Extensive
• Management Team	No change	Early appointments	Two left	Premature change of FD	Extensive when restructuring implemented	Significant re-organisation incumbent mgt
• Changes to Financial Structure	None	Revised payment schedule	Share buy-ins of departing mgt; requirement for further finance	Massive restructuring following market collapse	Acquisition finance followed by forced restructuring 1990,1991	Refinanced after 12 months to consolidate structure
Realisation:						
• Intentions	Succession	Remain private	Long term float, sale, releverage	None	Trade sale	Flotation
• Actual Realisation	Not yet	Not yet	Forced trade sale	Heavy dilution on restructuring	Restructuring and massive equity dilution	Not yet

Discussions with Team Leaders revealed major weaknesses in the team formations in both Metalliform and Slingsby. The first which was a small team in a relatively large buy-in, had not involved a full time day to day working relationship (the Leader having Group rather than individual profit centre responsibilities) and appeared to involve two quite different levels of background and experience where conflicts could exist. Indeed the Team Leader of this case reflected on the loneliness inherent in his particular position. Secondly the Slingsby buy-in had the largest team relative to company size, four members. The Team Leader was particularly incensed that the venture capitalist had strongly encouraged the formation of a larger Team than the Leader had initially considered necessary. All members of the Team had to relocate and in practice two of the Team failed to live up to the potential which the Team Leader had originally expected. While perfectly adequate in performing in management capacities in privately owned groups, they were unable to adjust to the differences required in a role as owner manager. In retrospect the Team Leader felt that his knowledge and the drive of one of the other members would have been sufficient; the extra two members were essentially superfluous and expensive to remove.

While larger sizes of Teams could be justified on reducing potential skills gaps, only two of the Teams (The Maids and James Neill) claimed that there were no skills gaps. The other four Team Leaders identified specific Financial skills gaps. While financial skills may be relatively easy to buy in compared to certain production, technical and sales skills, their absence at the planning and due diligence stages may lead to subsequent problems. This for instance was seen in AGK and Slingsby where more active early financial involvement would have helped to identify potential problems. The skills gap could also result in the delay of important financial actions. This was apparent most noticeably in Metalliform where the incumbent Accountant was replaced at too late a stage after buy-in, despite the Team Leader's early recognition of the Accountant's shortcomings. Team Leaders may themselves have some basic financial acumen and be able to

afford some cover for skills gaps, three of the six Team Leaders having specific managerial skills in addition to their general skills.

A major issue relates to the degree of entrepreneurial experience (2.3.3) which Teams may have had previously. Case study interviews showed the influence of a high degree of entrepreneurial experience in European Brands. Here the Team Leader had successfully managed the start-up and rapid expansion of a company and clearly saw himself as a 'serial' entrepreneur. He felt that this experience had been very useful especially in attracting venture capital funds. The Team at James Neill also had a high degree of entrepreneurial experience, including working for venture capital organisations. The other Teams had essentially been managers without previous experience of being owners. However in one case, AGK, the Team had attempted a management buy-out of their incubator company. While this had been unsuccessful, the experience had helped to nurture an entrepreneurial desire which had culminated in the buy-in. It had also provided a useful learning curve.

Even if Team Leaders did not have entrepreneurial experience, there were issues concerning how applicable skills learnt as part of a large company would be for running a smaller independent buy-in as well as how Team Leaders would be able to adapt to the different type of culture and level of back-up support. Three of the Team Leaders had worked previously for Top 500 UK companies with only two for privately owned companies. There was evidence that for instance in the case of Metalliform there were considerable problems involved in adjusting to these different levels. Certainly the change to private ownership had caused problems for two of these three, although that is not to exclude problems which arose with the transfer to working as a shareholder of a privately owned company.

Background characteristics of entrepreneurs (Chapters 2.3.2, 12.7 may have significant influence on venture performance. Team Leaders emerged as being well educated or with professional

backgrounds. The majority had university degrees and in one case the Number Two additionally had an MBA degree and were aged in their early 40s. Only one of the Team Leaders did not have professional parents, and in this case they were skilled rather than unskilled. This broad similarity of personal backgrounds does raise questions as to the selection process by venture capitalists and whether potential Team Leaders with different educational and personal backgrounds are disadvantaged in their approaches.

14.4 Identification of the Target Company

Consideration of the target company was seen to involve issues concerning the nature of the identification process, the reasons for the sale of the company by the vendor, the type of company being sold, whether there was an active market for control of the company and essential demographic features.

The way in which the company was identified in the first place was seen to concern the use of formal or informal networks. Teams may know of a target through their own personal contacts or may take advantage of more formal methods such as the use of professional advisers who may have access to more scientific methods of identification than the Team themselves. Additionally links may be sought with the Team's individual incubator organisations.

Cases confirmed that personal, professional and industrial contacts were the most likely to be applied with incubator organisations having particular roles to play. Three of the cases relied on knowledge gained in incubators whose activities were very similar to those of the eventual target company. A fourth has been obtained through an informal industrial contact. The remaining two appeared to rely more on formal networks, European Brands on approaches of a financial institutions while James Neill involved a much more scientific approach and a long period of active search using sophisticated techniques. Some had been able to make use of research carried out at their previous employment, eg The Maids' parent had been considered as a possible

acquisition target by their previous employer while Slingsby had been a member of a purchasing co-operative whose Secretary was the Team Leader. The impression given by the majority of cases was one of relatively casual rather than scientific identification methods where luck had played an important role. Team Leaders were motivated to carry out a buy-in but at the same time were prepared to wait a considerable period- even years- before identifying it. Team Leaders also did not involve their advisers in the search for a target, employing their advisers and normally approaching the venture capitalist after target identification. An exception to this was AGK, where the team had failed in an earlier attempt to do a management buy-out. Even in this case, however, the actual identification of the target was carried out by the management.

The reasons for sale provided a contrasting set of circumstances although basically could be summarised as either private owners seeking succession or re-definition of core activities by plc's with an under-current of performance problems in both main sources. This provided support for the reasons for vendor motivation outlined in 2.3.4 and the role that management buy-ins may play in the corporate restructuring process. Of particular note was European Brands, the buy-in of the buy-out, where institutions were seeking to replace an existing (under performing) management team. Motivations for sale to the buy-in Teams in particular could also be seen in some cases through the incumbent management being considered not to have the appropriate skills to manage the turnaround which would have been necessary to attract venture capital backing. In the Slingsby case, it was important that the Team Leader was a personal acquaintance of the vendor. It was also significant that Team Leaders in the interviews felt that private vendors were keen for the company to remain in independent hands rather than be part of a group.

Clearly motivations in the case of James Neill, which had been excluded from the questionnaire on the grounds of its public buy-in status, were different. There were large share holdings held in the company which were felt to be potentially hostile and general investor disquiet at the poor level of performance of the company. There was however a significant shareholding held by the

Neill family who were clearly attracted to the LBO alternative through the possibilities both for some continuing relationship with the company and for it to remain in independent hands with access to significant funds for investment and growth.

The survey revealed the influence of competition in the market for corporate control both through failed bid attempts for other target companies as well as competition from other bidders in three cases for the target company. As such it confirmed earlier findings that the buy-in process does involve an active market for corporate control and implicitly more competition than is evident for management buy-outs. As should be expected, the final clinching factor for selling to the case study Teams were the lack of alternative offers and the price being paid.

Consideration has also been given earlier in the Thesis to whether buy-ins are likely to be relatively homogeneous or whether there may be considerable differences in basic demographic characteristics; in particular there is the issue of whether buy-ins are seen to conform to the US LBO stereotype of being in mature, cash generative industries. A major feature of the majority of case studies was that achievement of their business plan objectives relied on expansion and significant cash requirements despite some of the industries being reasonably cash positive in terms of existing operations. The whole philosophy of AGK revolved around winning several major new contracts which would require significant expenditure on plant and machinery. Metalliform expected to double its turnover in the plan period with consequent working capital requirements; it also planned to make acquisitions. European Brands made a major acquisition requiring considerable additional funding. The Maids expected to grow significantly. Consequently the case studies indicate that while buy-ins may be in cash generative industries, the planned growth of the companies effectively reduced the cash generative potential in the short and medium terms.

The companies represented a variety of sizes and previous ownership forms. Although only one was actually loss making in the latest audited period prior to buy-in, they were all considered by the Team to be under performing. All Team Leaders felt that at the time of buy-in the Team possessed the skills necessary to achieve this turnaround. Team Leaders saw that an advantage they had was their ability to improve performance and this was recognised both by the vendor and the venture capital firms. Such lack of profitability was seen to be a common and important reason for the previous owner seeking a sale. Examination confirmed the relative lack of profitability of the case studies, with the majority earning inadequate returns as implied by the ratio of deal value to operating profit. Teams in appraising the target company had felt confident that the reasons for previous under performance were identifiable and could be corrected. For instance Slingsby was seen to be suffering from the current generation of family ownership losing interest, The Maids because of poor control and service and being outwith the main focus of the parent and Metalliform because of the financial state of the parent (part of the Maxwell group). Thus a major common underlying factor was the belief that the targets were not performing as well as they should and the new management would be able to bring the appropriate transformation.

14.5 Transaction Completion

The case study interviews throw further light on the issues arising in the transaction process. Both the roles of advisers in the identification of appropriate financiers and in the overall negotiation process differed between cases. Entrepreneurs may experience difficulties in seeking appropriate advice and where necessary may initially use advisers with whom they have had a previous professional or personal relationship. This, of course, may not be ideal in the context of specialist advice such as a buy-in. The Slingsby Team Leader for instance initially used an old contact as accounting adviser who failed to perform; change to another clearly delayed the buy-in process significantly. Another example of using earlier relationships was The Maids where an ex-colleague was now employed as a consultant at Ernst & Young. In this case no problems with the adviser

were identified. In general accounting advice offered to the Team was seen to have been competently delivered although there were concerns in one case over the quality of personal tax advice. A criticism made by the majority of case companies was that they felt that the fees charged by their advisers was excessive.

Advisers' most important role appeared to be in helping with Team to select a venture capital financier, where the accounting adviser to management emerged as the key intermediary, approaching them and arranging meetings. This was often done very quickly, eg virtually over night in the case of Slingsby. In one case, AGK, an earlier buy-out attempt had introduced the Team to 3i; this had resulted in a continuing relationship between Team Leader and venture capitalist.

The availability of funding for small regional transactions is a major issue. Such lack of alternative local venture capital sources may contrast with considerable competition by venture capitalists for larger sized transactions. In general lack of availability of alternative equity finance sources at the lower levels of deal size was noted. As the deal size increased, the more alternative approaches to financiers the intermediary advisers were able to make and a "beauty parade" of up to twelve potential funders held. Thus The Maids relied essentially on an approach to a local office of 3i with no other local venture capitalists being present. Slingsby involved seeking funds through Leeds based advisers in London. In the cases of the two largest private buy-ins, European Brands and Metalliform, advisers were able to interest over a dozen venture capitalists in providing equity finance.

Such competition for the business could be seen in the equity terms which were agreed for the buy-ins. Four of the five private buy-ins involved initial management stakes of at least 60 percent, a level which in retrospect may be considered to have been too high given the risk factors involved. Advisers had successfully played potential financiers against each others in several cases.

The way in which the financing structure helps to create the conditions which encourage efficiency and cost saving resulting in performance benefits is crucial to corporate restructuring (Chapter 2.5.1, 2.6.1) involving both financial control and monitoring by the financiers and the financial commitment of individual Team members (and hence their incentive to perform); this may also be supplemented by other forms of incentive such as ratchets. Only the smallest did not involve a ratchet on management equity percentage. Another aspect was the considerable diversity in the amounts of management contribution, this in the case of the Maids, the smallest buy-in, being in fact larger than for the next three buy-ins. Indeed the amount of management capital in buy-outs and buy-ins appears inversely proportional to the size of the transaction!

It was also clear that ratchets were an important element of financial structures. Advisers had negotiated their inclusion to provide more upside for Teams and competition emerged between financiers for better terms. Management appeared to encourage these improved terms, feeling that conditions attached to them were realistic and that it was part of the function of their accounting advisers. By the time of the case study interviews, the prospects of original positive ratchet effects being achieved had become highly unlikely. AGK, Metalliform and European Brands all had produced disappointing operating performance despite the determination of managers to introduce corrective measures. Management appeared to be resigned to this development. This supports the earlier finding (Chapter 13) that the presence of equity incentive devices which should be a major control device to put pressure on management to improve performance under normal corporate restructuring considerations, was not sufficient to offset the problems encountered by these of buy-ins.

The effect of debt bonding had also been identified as an important factor in corporate restructuring. The gearing ratios of the case studies varied considerably, partially reflecting the type of financial instruments used, eg subordinated loans being provided by some institutions as opposed to preference shares. As noted above the banking conditions were seen by most Team

Leaders to be restrictive, yet if one of the advantages of corporate restructuring comes through the debt bonding effect, this may be the most effective way of implementation. This can be seen in the restructuring of Metalliform, where the trigger for urgent action was the pressure put on the company by the bank threatening to call in receivers as certain financial accounting ratios defined in the banking covenants were triggered. There was a feeling in one case, The Maids, that the real bonding effect was not through the corporate covenants but rather the commitment on their personal financing such as the second mortgages which had been taken out. A further notable aspect of all the cases was the relatively subservient role of the clearing banks compared to equity financiers (except in the special case of backing for AGK where a high degree of asset finance was required); these were brought into the deal process at a late stage.

Teams had varying experiences of the due diligence mechanism, shedding some light over the 'skeletons in the cupboard' experiences noted in the questionnaire survey. A major problem had been in obtaining adequate up to date information concerning the company especially in terms of management accounts and indications of current trading and the status of major contracts. Thus in Slingsby and AGK the level of business actually being transacted was significantly less than indicated to management. There were also concerns as to the robustness and accuracy of previous audited accounts which led to the consideration of legal action (European Brands) and actual legal action (The Maids). Appropriate assessment of valuation of stock and fixed assets had not taken place in both AGK and Slingsby. In theory the process of due diligence must be rigorously applied although in practice if deals are to be completed, management and their financial backers have to make realistic decisions which may leave some exposure to future risk. In retrospect, in the majority of cases insufficient thoroughness was exercised in the due diligence process to ensure risk was at acceptable levels. In one case, Metalliform, the risk had been effectively reduced through the Team Leader's previous group relationship; even so a warning in the due diligence report concerning the stability of local education authority purchasing arrangements had been effectively ignored, leading to considerable problems in the second year of the buy-in. While

relationship between the Team, other directors and the venture capitalist is fundamental to the company and the nature of the relationship important. This was seen in the care taken initially in most cases to ensure that the external non-executive directors were acceptable to the Team.

Issues arise as to how refinancings can be structured to keep management motivated to perform. In the case of funds being required to expand through acquisition, the European Brands team recognised the inevitability of equity dilution, being prepared to accept this on the basis of retaining a share of a larger company which they saw as being worth more than a larger share of a smaller company. The restructuring in Metalliform, caused by the collapse of its main market following changes in local education authority purchasing arrangements, was more controversial and involved major criticism by the Team Leader of the degree of support offered by his venture capitalists. The nature of the business problem was seen to be the reaction to a one-off collapse in demand for the company's products. Change in purchasing patterns would in a 12-18 month period result in a resumption of demand but in the interim major restructuring would be necessary requiring financial support. An action plan was worked out with accounting advisers but one of the two venture capitalists was unprepared to support this. The Team Leader ascribed the lack of support to a low level of involvement in the company since the buy-in resulting in a failure by the venture capitalist to understand the business. This feeling was increased through the investment executive sent by the venture capitalist to consider the restructuring alternatives being seen as a young accountant with little industrial understanding. Conflicts clearly emerged between the two venture capitalists, one of which was broadly willing to support the company. Given the seriousness to the survival of the company, the Team Leader had to find new local sources of finance which involved accepting much reduced levels of equity share. It was notable that the Bank of Scotland supported management throughout this process.

A further example of the need to maintain incentives for Teams was seen in the case of Slingsby where two issues were important. First the departure of Team members involved the sale of the

In AGK indirect representation (through the use of non-executives who were both members of staff of the venture capital firm) was used resulting in inefficiencies in the venture capital process in terms of the quickness of response to impending problems. Team Leaders' advice was however sought on the choice of non-executives.

The lack of interest in controlling at board level was surprising and may be part of the explanation as to why performance was disappointing. If venture capitalists who are supposed to add value to the investee company by their board influence are not exercising this right, difficulties may arise. This was clearly evident in Metalliform. Failure to control the company in this way led to misunderstanding by the lead venture capitalist of the business when it was faced with severe difficulties. NatWest Ventures were also severely criticised by the Team Leader for the quality of investment executive sent at this point, an accountant without industrial experience being considered inappropriate. The subsequent restructuring of the business was then made considerably more difficult with divergence of views between the two venture capitalists.

The presence of extensive monitoring by the venture capital firm and the appointment of non-executives with relevant sector experience does not by itself mean financial success. For example European Brands, a company with high quality non-executive directors and well controlled by the lead investor, at the height of the M & A market made an excessively costly acquisition despite having gone through an extensive screening process for the required incremental finance. As such the findings of the case studies may provide evidence which could not be identified from the questionnaire survey as to the subsequent relatively poor performance of the sample. Indeed the relationship between the Team, other directors and the venture capitalist is fundamental to the company and the nature of the relationship important. This was seen in the care taken initially in most cases to ensure that the external non-executive directors were acceptable to the Team.

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A further example of the need to maintain incentives for Teams was seen in the case of Slingsby where two issues were important. First the departure of Team members involved the sale of the departing members' shares. The remaining members of the Team no longer had financial resources to increase their holdings, leaving the venture capitalists to make the purchase. This further increased the hold of the venture capitalists over the company. Secondly the reluctance of the venture capitalist to support an expansion plan put forward by management led to the

trade sale of the company. This exit however was carefully engineered so that management could exit without financial loss should certain performance targets be achieved and also illustrates the proactive stance taken by venture capitalists directly represented on the board

14.7 Post Completion Actions and Problems

Incoming Teams were aware that to achieve the turnaround in profitability of the target company, a carefully arranged plan of major operating and strategic action would need to be implemented after buy-in.

However after buy-in the majority of companies interviewed had been hit by certain frequently unexpected problems greatly complicating the recovery programme which had been planned before completion and altering the planned mix of intended actions. Indeed one Team Leader commented that he had 'been to hell and back'. Such developments reflected major declines in the business which had taken place between the previous audited accounts and the point of buy-in, perhaps partially attributable to the first signs of recession, but also raising questions as the reliability of the audit and the state of accounting control systems in the target.

In assessing a target company, Teams rely on both their own knowledge, experience and investigative abilities as well as the advise given by their own accounting advisers and the reporting accountants appointed by the venture capital firm. Despite the breadth of these investigatory efforts, it was clear that decisions had been made in some cases on the basis of either inadequate or misleading information. Problems were reasonably widespread and costly. There were cases of stock being valued at unrealistically high levels as a result of over age elements (eg Slingsby), fixed assets being in a state of disrepair which had not been fully allowed for (AGK), accuracy of previously audited account (European Brands and The Maids) and the stability of contracts (AGK and The Maids). While legal action can be contemplated against auditors (eg European Brands) or even taken (The Maids), such developments are costly in both

time and expense and provide a major diversion for the Team Leader. Team Leaders recognised the importance of careful wording of warranty provisions while one (The Maids) was adamant on the need for legal expenses insurance.

While much of the rationale for the buy-in appeared to revolve around strategic actions- eg the development of new brands, entry into new markets- these proved difficult to achieve because of the time diversion as efforts of a more operating nature had to be implemented to correct frequently unforeseen problems. Consequently plans of a more strategic nature were effectively delayed by at least a year while management devoted time to operational strategy. In some cases, eg European Brands and The Maids, the possibilities of legal actions consequent to due diligence failures caused further distortions to plan implementation.

In the cases of the 1988 and 1989 buy-ins, by the time such actions had been carried out, economic and financial conditions were deteriorating. This resulted in major difficulties emerging in being able to proceed with the original strategic aims. A major element was a series of actions to achieve rapid growth- eg development of new products, entry into new markets, acquisitions. These became very difficult to implement with much attention continuing to have to be placed as basic operating actions such as debtor and creditor control to conserve cash flow and overhead cost control. Metalliform and AGK in particular faced extremely serious problems in their second year as turnover projections could not be achieved.

The case studies also provided further insight into managerial changes and whether or not a management buy-in Team can stay together. In the majority of cases significant management changes were implemented shortly after buy-in, usually leading to the dismissal of previous key managers. These involved not only direct replacement by Team members but also other recruitment. Team themselves had sometimes to be re-organised. In the Slingsby case two of the Team were forced to leave because of non-performance. The Sales Director, who had been

successful in his previous position, survived two years, but proved in the Team Leader's view 'not up to the job'. Specifically he was not appropriate to an environment which required emphasis on field sales as opposed to being an inside salesman. The second person to leave, who had been put in charge of the warehouse and transport, was asked to leave after six months, the Team Leader being 'staggered' at his failure to adapt to changed circumstances and additionally how little he appeared to know. In retrospect it was felt that this person had been protected for the previous fifteen years under a Director who had retired from the incubator company at the time of the buy-in.

A further problem area was the effect of relocation which may initially restrict the initial local market knowledge of the Team as well as leading to major personal problems, including high levels of stress. AGK faced particular strategic problems given their need to diversify into new markets and the Business Plan's reliance on achievement of phased expansion. The Team Leader remarked on local marketing problems. Slingsby and Metalliform Teams were away from home for the working week with stress problems evident.

Problems also existed in correctly appraising non-Team members. This was particularly evident in the case of Metalliform, a small team. The Accountant was recognised initially as being more a book-keeper rather than having the potential to be Finance Director. As he was only two-three years away from retirement, the Team Leader decided to retain him and delayed appointment of a Finance Director. This led to considerable problems when a restructuring plan had to be formulated, the Team Leader having to write the plan in conjunction with external financial advisers.

The failure of buy-ins to achieve expected levels of profitability may have parallels with studies of low performance following corporate acquisition. Evidence from the case studies clearly poses questions as to the exhaustiveness of due diligence procedures as well as the extent of the decline

in the company's fortunes had the old system of ownership remained. Without the new emphasis on action, the subsequent decline in performance may have been much greater.

14.8 Initial Performance

The overall sample provided evidence of a disappointing level of buy-in performance compared to earlier surveys of buy-outs, although these must be qualified by different time frameworks. The case studies showed in the main a failure to achieve targeted levels of profitability, and there were no outstanding performers. As such they provide both additional and supporting evidence for reasons for poor performance as well as the course of action which was embarked upon under the new governance arrangements.

External pressures were frequently blamed for the failure to achieve target, and actions taken by management at that point did not always significantly improve profitability. As the venture capitalist and bankers began to perceive the seriousness of the under-performance (in some cases delayed through laxness of their monitoring and control systems), they initiated external action, paralleling developments which may be expected under the late recovery stage which may be derived from the Cyert and March model. This can be seen for instance in the belated management changes at European Brands and the background to the forced trade sale at Slingsby.

There was variation in terms of the direction of initial profitability of the target company, ranging from significant shortfall to marginal improvement while the two largest private buy-ins were later hit by the need for massive financial restructuring. Both of these buy-ins had been early acquirers of other companies. European Brands, in particular, suffered from not being able to obtain the expected benefits from acquisitions; these were made at a time when the new management's ability to turnround the original target company was hardly proven. Only one company did not need to change its buy-in financial structure. It also did not appear that the most highly qualified

Team Leaders in term of level of education or management status reached were necessarily the most appropriate at achieving the improvement in performance required.

A good example of the problems which can be faced was seen in the case of AGK. Here management were operating in a geographically new region with the aim to strategically re-orientate the markets in which the company operated. In this new area they lacked initial credibility, had no effective track record and suffered from financial credibility through lack of realistic accounts being a new company.

The disappointing level of buy-in performance (Chapter 11.2) and lack of significant difference in performance between entrepreneurial types (Chapter 12.4) can be seen in this group of cases with only one opportunist performing marginally better than Plan. While Chapter 13.3 has shown the importance of previous personal knowledge, all five private buy-in cases analysed had (varying) extent of previous working relationships. In the view of the Teams themselves, this was an important factor in the ability to successfully complete the buy-in. Skill gaps did exist and in one company, Metalliform, may have contributed to, but was unlikely to have been a determinant of, poor performance.

While gearing had not emerged as a determinant of poor profitability (Chapter 13.3), some Team Leaders did comment that higher than average gearing did cause problems: these resulted in problems in obtaining credit status (limiting ability to win contracts) as well as providing reduced flexibility against a background of economic downturn and high interest rates, there being little slack left in the system. The Slingsby Team Leader in particular felt that their stability had been threatened by high gearing. Clearly the cases of European Brands and Metalliform also illustrated that initial financial structures could not be maintained in the difficult economic and financial conditions towards the end of this period. It is however significant that the initial performance

of the two earlier cases, Slingsby and European Brands, were also disappointing even before they were brought off course by recessionary conditions.

As detailed in 14.7 considerable problems emerged in the majority of case studies; an issue which emerged was whether a major element of this reflected poor diligence procedures and if so whether these were particularly serious in specific types of company. It was clear that target companies which were reliant on more rigorous regulatory control pre buy-in (James Neill as a quoted company and Metalliform as a subsidiary of a quoted company) were less likely to have suffered from major problems not noticed in due diligence. In the case of Metalliform a problem had been correctly identified but discounted by management. In contrast performance shortfalls because of failure to identify problems at the due diligence stage appeared to be a feature of privately owned companies where internal management accounting standards were found in retrospect to be lacking.

14.9 Realisation

Earlier discussion has shown that the different risk factors seen to be involved in buy-ins compared to buy-outs may produce different attitudes by Team Leaders to exit as well as actual different returns as well as showing some areas where there may be similarities. Although many venture capitalists may assume in their financial projections that an exit will be obtained from their investee companies within 3 to 5 years, and some would argue (eg Rappaport 1991) that buy-outs are essentially a short term form, analysis of exit intentions and realisations achieved confirmed the diversity which has been seen in UK buy-out studies (Chapter 2.6.2) and the overall results of the buy-in survey (11.5). Intentions ranged from ambitious and quick trade sales to family succession, ie spanning the range from permanent form to essentially a short term phenomenon. Furthermore failure to perform produced major problems in term of restructuring and dilution of managerial equity. While no changes were necessary for the two smallest buy-ins,

the next largest only escaped heavy restructuring through a trade sale while the two largest ones required heavy re-structuring.

Evidence as to the potential life cycle of buy-ins was of course too early to obtain for the survey companies although intentions provided interesting pointers to potential conflicts with the supporting venture capitalists. These intentions in the main were surprising in that most Teams wanted to remain independent, several not having any exit intentions at all. This may partially reflect the institutional backers of the buy-ins and different approaches by them. For example the two largest buy-ins had investors who managed closed end funds: they had clear aims as to exit. The two smallest, backed by 3i, had no obvious exit intentions.

Exits may of course not happen in the way which was originally intended. Evidence was provided for this both in terms of the forced restructuring of two of the case studies (European Brands and Metalliform) which reduced management's share although allowed the company to remain independent. The latter also illustrated the problems which may emerge in joint and syndicated transactions, where there may be divergences of opinion between investors. The one exit achieved, Slingsby, had not been the initial preferred option, it being forced on the company by the institutional backers who were unprepared, given disappointing financial performance, to support the long term growth of the company. Indeed the Team Leader commented that venture capitalists are only prepared to take the long term view when things go well. The case studies appear to give strength to other findings on buy-outs that exit may be in a form which was not originally intended.

14.9 Comparisons with LBOs

Comparisons can be made with the more LBO style of operations of James Neill. In this case the buy-out represented essentially an institutionally mounted acquisition of an under-performing company. Considerable sophisticated resources were spent trying to identify the target and

carrying out due diligence. Managers seconded to James Neill were given high degrees of incentive compensation. The transaction involved an extremely high degree of monitoring and control. The immediate aftermath of the buy-in allowed both strategic and operating strategies to be implemented.

The manner of appraisal allowed a full programme of actions to be implemented immediately following completion. The resources of the venture capital firm were extensively used including the industrial knowledge of partners. Surplus subsidiaries were quickly sold although this was balanced by purchases of other companies. The direct involvement of the venture capitalist avoided the problems of divergent aims of the Team and financial backers and enabled refinancing to be carried out within a previously suggested time table.

A critical consideration is whether this alternative form resulted in superior selection of investment in terms of subsequent performance. Initial performance appears to have close to plan but the recession is believed to have subsequently curtailed the opportunities for development of the company and produced results which must be considered disappointing in terms of the original objectives.

14.11 Conclusions

Overall the case studies have helped to shed light on some of the main issues raised earlier in the Thesis as well as the findings from the questionnaire survey.

While the economic recession clearly affected the performance of the target companies, other factors which should have reduced this problem were offset by failure to correctly identify problems before the buy-in took place. In particular management equity incentive mechanisms did not seem to be enough to prevent the downturn in performance.

The reasons which emerged in case study interviews for this under-performance reflected both the particular problems of target investigation which can be seen in completing a buy-in rather than a buy-out (some of which may be related to the source of buy-in) and also the effects of recessionary and high interest rate pressures on the financing structures.

The importance of the composition of the buy-in team needs to be stressed. Large teams in small companies appeared to lead to problems while previous working relationships between Team members were necessary but not always successful.

Buy-in completion through involving the purchase of a company of which the incoming Team may know generally but does not have specific knowledge implies a considerable risk factor which appears to have been under-estimated. Due diligence procedures typically did not reveal major downwards risk factors or even misrepresentation of assets or current year performance which are known to management in buy-outs. Remedies for these unexpected factors take time, which may not be available. Buy-ins, like turnarounds, may require to be judged over a long period for the complex of actions taken to be shown to be effective. Similarly there is evidence that corporate acquisitions may not perform as satisfactorily as originally expected.

The case studies also confirmed the problems of completing transactions in the late 1980's, as indicated in Chapter 13.3. While Teams and their advisers and financiers should have been able to apply appropriate sensitivity analysis in their appraisal of the target company, the combination of paying too much for a target and having to fund a large proportion of this excess price through debt instruments brings considerable instability if there is a combination of substantial increases in interest rates and economic recession.

A major issue relates to the control and aims of the venture capital backer. There was evidence in the case studies that venture capital firms were not exercising their control functions

appropriately which led to both a reduction in the value added that they could contribute to the development of the company and to a failure to appreciate performance difficulties to emerge. While venture capitalists in general will plan for exit, there was evidence that the aims of Teams and their venture capital backers were diverging. This could result in serious relationship difficulties.

Clearly the Team Leaders found disappointment in the performance of their companies and in some cases with the members of their team. At the same time they still appeared to be prepared, if given the opportunity, to pursue a second buy-in should that possibility arise in the future, feeling themselves able to use the experience learnt in this initial buy-in.

CHAPTER 15

CONCLUSIONS

15.1 Introduction

This thesis has presented the results of the first major study of management buy-ins in the UK and examined their differences with management buy-outs. It has sought to identify characteristics of both Team Leaders and target companies, types of action taken following the buy-in, initial performance and life cycle intentions showing differences with buy-outs. The theoretical, empirical and case study elements of this thesis have been able to confirm that management buy-ins are a significant corporate restructuring form in their own right despite some similarities with management buy-outs. In particular Buy-in Team Leaders appear more 'opportunist' than buy-out managers and pursue substantially more innovative actions. Performance, however, in the short term, was disappointing, although heavily influenced by a particularly adverse economic and financial background.

The thesis examined the management buy-in process in terms of the restructuring opportunity, Team Leader and Team, infrastructure aspects, deal completion and post transaction issues including governance, performance and realisation. This Chapter draws together the findings of the theoretical and conceptual discussion and the empirical and case study evidence (15.2) to highlight the main conclusions. Policy implications for government, venture capitalists and Teams are raised and given the relative newness of management buy-ins and the consequent limitations this has placed on the study, areas are suggested for further research (15.3) before stating the final conclusions of the Thesis (15.4).

15.2 Issues and Findings

Chapter 3 noted how management buy-outs and buy-ins could be seen principally in terms of corporate restructuring and entrepreneurship- but with important interactions with some other

areas. It could be expected that the two ownership forms, despite some basic similarities, would result in different actions and hence outcomes.

The case was made that both management buy-outs and buy-ins are part of the corporate restructuring phenomenon. They both enable management and ownership to be brought together in a new combination in partnership with specialist financiers. Buy-out and buy-in financial structuring involves considerable emphasis on management equity incentives and the bonding effect of debt instruments while strict monitoring and control by the external equity holders places a very important control on ensuring that operational efficiency is enhanced. It was also argued that Teams in both management buy-outs and buy-ins would show higher degrees of entrepreneurship than is common in conventionally owned organisations and this would help to improve performance further. The management buy-in, through involving external management entrepreneurs, was thought likely to bring a higher degree of entrepreneurial action and change than evidenced in buy-outs. It would also benefit from the role of new management in importing new vision and direction to under performing companies. The types of target companies sought were also considered to have some distinctive characteristics while the different risk factors involved and more innovative plans may result in distinct realisation and life cycle patterns. Performance was seen to be related to both entrepreneurship and corporate restructuring characteristics.

The empirical and analytical part of the thesis confirmed a considerable number of the propositions and hypotheses derived from the synthesis of the theoretical aspects although the apparent performance shortfall, in particular, raised a number of further issues. Buy-ins and their Teams appeared to have distinct qualities compared with their buy-out equivalents.

Close similarities in backgrounds between buy-in Team Leaders and entrepreneurs surveyed in other studies were noted. A substantial number of buy-in Team Leaders had previous business

ownership experience; had small business owners as parents; were frequently well qualified in terms of professional qualifications and university education; were attempting the buy-in as part of a mid-career change in what had been a relatively stable employment background; were likely to have known each other before; and were making the move within the same industry. In comparison, buy-out Teams were smaller and, not surprisingly, the identification and the process of completing the buy-in took longer than for buy-outs. Target company identification was highly reliant on the Team Leader's knowledge and contacts, informal networks being more important than formal networks.

Buy-in Team Leaders could also be seen as falling into the classic entrepreneurial typologies with the majority being essentially opportunist but a minority craftsmen; unexpectedly there was a small "push" element. Analysis of differences with buy-outs saw the latter as being far more craftsmen orientated.

More entrepreneurial orientated Teams than in buy-outs could be expected to lead to significant differences in terms of the type of actions pursued after deal completion with Team Leaders bringing a new vision and direction for the company. Significant differences with buy-outs were noted in areas such as financial control, marketing, production and administration. Team cohesiveness (as measured by "resignations" within the Team) was very similar to those in buy-outs despite the greater stress and other pressures in buy-ins.

In terms of the corporate restructuring phenomenon buy-in financing structures were reasonably leveraged, although less so than buy-outs of the same period. There was a high equity incentive seen through the presence of ratchet devices. The nature of target companies again differed to some extent from the conventional buy-out company especially with regard to industry growth potential and future cash requirements, where buy-ins were expected to require additional funds for organic expansion and also to make acquisitions. Sources were significantly different with buy-

ins being more likely to come from private owners rather than subsidiaries of public companies. Buy-ins also appeared to involve a higher degree of monitoring than buy-outs.

While these differences with buy-outs have been noted, the key question is whether buy-ins result in a form of organisation which has superior features to those of buy-outs especially in terms of performance and life cycle characteristics. Here evidence appeared disappointing with both buy-in financial operating performance worse than seen in buy-out surveys and buy-ins being significantly more likely to fail. Furthermore linking performance to certain key entrepreneurship and corporate restructuring variables did not show up significant differences in areas where they would be expected. Thus the opportunist Team Leader's performance was not significantly different from that of the craftsman. The discriminant analysis did not find gearing or type of venture capitalists a determinant of performance while the presence of a ratchet, seen as a key incentive device, in fact produced a negative relationship. This may of course reflect the effects in adverse circumstances of the more marginal nature of some transactions where ratchets may have been imposed because of valuation disputes between Teams and venture capitalists during deal negotiation rather than acting simply as incentive devices. The year of the buy-in as well as the source emerged as important determinants.

It can be argued that the year effect reflects the exceptional economic and financial conditions around the time of the survey in February 1990 which affected 1988 and especially 1989 buy-ins. Buy-out experience also shows an abnormally high rate of receivership of deals completed in 1988/89, although far less so than in buy-ins. As shown in Table 11.2, economic and financial conditions were severe: the later buy-ins were almost immediately faced with interest rates of at least 15 percent and an economy entering serious recession. Given the re-organisation and turnaround elements contained in many buy-in Business Plans the margin for error under these circumstances was unusually low. The better performance of the 1986 and 1987 companies in the

survey may reflect their having achieved initial restructuring and target strengthening before the contextual factors became so adverse.

The theoretical seriousness of the situation is worsened by considering the entry Price Earnings (PE) ratios of 1988 and 1989 buy-ins. Stoy Hayward (1993) show virtually no difference between PE ratios of quoted and unquoted companies in 1988/89. However the classic buy-out and buy-in scenario is to invest when this PE differential is large, ie complete deals when PEs of subsidiaries and other unquoted companies are low but exit at prices which reflect high quoted company PEs. Given the implications of financing leveraged structures when the differentials between these PE ratios are low, the scope for failure to achieve performance and realisation objectives must be high. Indeed, given these circumstances, the actual results must be seen more favourably.

The issue then arises as to why venture capitalists were prepared to go ahead under these circumstances. Some indications may be derived from US experience. For instance Kaplan and Stein (1993) have pointed out the effect of large sums of money being available from 1985 through junk bonds for buy-outs; this significantly increased the prices which practitioners were willing to pay for target companies. In the UK there is evidence of high rates of equity and mezzanine fund raising in 1988-89 and large debt availability in this period which may have resulted in similar effects. UK venture capital in the mid to late 1980s also saw a large number of new entrants and increasing competition between players (Robbie and Murray 1992).

As well as the implications of these competitive pressures and the failure to assess the impact of the recession and high interest rates, issues arise from the results of the Questionnaire and the Case Studies as to the effectiveness of venture capital due diligence procedures. In a management buy-out, the venture capitalist is helped by management's record in and deep knowledge of a business. In the buy-in there are more unknowns: part of the venture capital process, however, is to identify as many of these as possible and make revised judgments as to the risks involved

before agreeing final terms. Due diligence applies not only to the target, its industry and the Team but also to interpreting trends in the wider economic and financial context. It was clear that this process was not carried out to a sufficiently comprehensive extent in many cases. Reasons for such failure are varied but will reflect both the cost pressures of due diligence reports, the prospect of fee income on transaction completion and the need to agree terms quickly given the highly competitive market for equity finance at the time. Failure to identify problem areas not only led to their discovery later but also to the use of financing structures which were inappropriate. In particular management may have been given too large a share of equity as venture capitalist tried to gain business.

Once into the deal a key element of corporate restructuring is the installation of new governance systems by the venture capitalist which inter alia allows quick identification of problem areas and compensatory action to be taken. Evidence from the case studies indicated that this did not appear to have happened in all cases: there can be little doubt that more active investor involvement would have helped to prevent further major decline in these companies.

A further issue concerns the type of company purchased and whether it was suitable for restructuring by management buy-in. US experience has concentrated on larger transactions, frequently going privates, where there are high standards of existing information and clear agency cost savings. In contrast a large number of UK buy-ins have been relatively small and from privately owned companies. Smaller companies and those that are privately owned may not necessarily have the same scope for reduced agency costs. They may for instance involve relatively high monitoring and control costs leading to the venture capitalist concentrating more on the larger deals in his portfolio, where the overall sums at risk are higher. There is also the danger that given the low overhead element of some family owned companies there may not be significant amounts of cost saving that can be applied. Many small privately owned companies may not have the degree of information available to ensure that due diligence can be satisfactorily

completed. Case studies consistently showed in the case of private companies that information and accounting systems at the time of takeover were inadequate.

It is also important to see buy-ins in terms of the re-organisation which is required after completion. With a high motivation to purchase a turnaround company, which involves a sustained period of rectification action, Teams can be seen to take longer to achieve the efficiency improvements which incumbent management in a buy-out can introduce in a short time. The improvements sought in buy-ins are wider and hence take longer, especially if there are initial unforeseen problems as a result of information asymmetries or inadequate due diligence. As in turnarounds improvements are a long term process. The short period between completion and the survey may not have been enough to see the beneficial effects of the complete restructuring process.

The longer term view is evident in the way that the decline in buy-in performance has been arrested. The past two years has seen some improvement in patterns in survey companies with no receiverships within the sample between September 1992 and 1993 and in terms of the overall CMBOR database a sharp reduction in the rate of receivership. Successful exits have increased. This gives encouragement to the notion that buy-ins can perform well in more propitious economic and financial backgrounds and that lessons have been learnt by venture capitalists following the experience of buy-in under-performance and failure in 1990 and 1991.

15.3 Implications of the Research Findings

The findings summarised above have clear policy implications in terms of government policy, venture capitalists' policies towards management buy-ins and the policies of management and entrepreneurs towards management buy-ins and venture capital firms. These, together with implications for future research are considered in detail below.

(a) **Government Policy Makers**

Management buy-ins can be seen to have implications for government policy makers in terms of competition and mergers policy, employment, taxation, the new issues market and accounting regulations.

First management buy-ins need to be recognised as a valid option to more traditional methods of trade sale, merger, acquisition and management buy-out in corporate restructuring. They may be seen to have distinct advantages in two main policy making areas: first competition and mergers policy as seen in the workings of both the Office of Fair Trading and the Monopolies Commission and secondly the use of insider information (as established both in legislation and the workings of the Takeover Panel).

In terms of competition and mergers policy, management buy-ins, like management buy-outs, may have considerable advantages in ensuring that divested parts of groups are not sold to other competitors in the same market place. Sale to an external management group will avoid further concentration of market share and hence conditions which may have been susceptible to extending restrictive competitive practices. Competitive forces in the relevant markets may indeed be expected to increase, given the high priority seen to exist in terms of actions taken by the incoming management to revitalise the company, adjust prices and introduce new products which may be expected to result in enhanced competition. In the medium term, having improved an initial market position, different factors may evolve which may then lead to the strengthening of the new company, although as in a buy-out subsequent acquisition activity may in itself lead to referrals to the OFT or Monopolies Commission (see eg Wright, Thompson, Dobson, Robbie 1992 re bus buy-outs). Differences have been seen in the life cycles of buy-ins compared to buy-outs implying that buy-ins may be able to remain in an independent and competitive form for longer than equivalent buy-outs.

A major criticism of buy-outs has been the concern over the possession of insider information both in the cases of divestment and going private buy-outs. Despite official policy through the Takeover Panel and Stock Exchange regulations controlling going privates and Class IV divestments there are still considerable institutional concerns as to the ethics of such buy-outs and the extent of such distortion to shareholder value. While a major problem from an external purchaser's view may be the lack of accurate information, the management buy-in, as in a more traditional trade sale, avoids criticism which may arise from management being in possession of insider information. This is of particular importance in the public buy-in. As seen in the results of the survey, the majority of private buy-in bids were in competition with rival offers made by incumbent management or trade purchasers indicating that an active market for the target company's assets existed: this must help to ensure a value for the company which is acceptable for the selling shareholders.

Additionally the results of the survey did not show abnormally adverse employment effects from what would have been expected under alternative methods of corporate restructuring. Given that the incoming Team were providing innovative ideas which would strengthen and grow the company, government should encourage further development of buy-in transactions.

Despite the environmental factors influencing the development of management buy-ins in the UK being much more favourable than a decade ago, policy makers should be aware of three areas where improvements could make the management buy-in process smoother: the overall personal and corporate taxation system and rates, the realisation of investments and the auditing and submission of company accounts.

While the UK government has created a generally favourable corporate taxation system (including for instance the deductibility of interest) major problems have existed in the past for entrepreneurs and venture capitalists in terms of the realisation of capital gains or the offsetting

of losses made on investments. Changes announced in the Finance Bill (1993) allowing the rolling forward of gains if proceeds are re-invested in unlisted companies, as well as a reduction in the retirement relief qualifying equity stake, should help to alleviate the long term problems raised by this issue.

Secondly, while the new issues market currently has the capacity to allow successful medium and large buy-ins to float, there are problems arranging for an exit, other than by a trade sale, for buy-ins with an original transaction value of less than £10 mn. This is especially important for teams who may wish to remain independent. Although the USM in the early and mid 1980s was able to do this for management buy-outs, the decline in importance and attractiveness of this market since then has meant that this exit route has only rarely been possible for management buy-ins. The size distribution of buy-ins as shown in this Thesis is such that many are unlikely to have reached the £25 mn capitalization value generally considered to be necessary to achieve a full listing flotation. Similar problems have also been identified on a European scale (eg Bygrave et al 1992). The review of the USM currently in progress should take account of the need of an alternative market for smaller companies where costs are significantly lower than the Official Market and marketability and liquidity problems are reduced.

Both responses to the questionnaire and case study interviews revealed considerable concerns as to the quality of audit work carried out under previous ownership (especially of privately owned companies) as well as delays in the provision of statutory accounts when Teams are engaged in the target company search process. These raise general issues concerning standards within the accountancy profession as well as the efficiency of policing by the DTI of companies accounts regulations.

(b) Venture Capitalists

The Thesis has provided considerable evidence that the risk profile of management buy-ins in terms of the likelihood of failure is significantly different from that of buy-outs and that in the original financial structuring of many management buy-ins completed in the late 1980s not enough attention was paid to these differences. Such transactions were completed against a background of a maturing and increasingly competitive venture capital market and the peaking of the mergers and acquisitions market and were followed by severe economic and financial conditions. Lessons still require to be learnt in five main areas- financial structuring, type of company targeted, Team selection, the due diligence process and governance structures.

On average buy-ins are structured with more equity than buy-outs but the difference in proportion of equity is statistically not significant despite the overall risk profile, for instance as measured by the propensity for receivership, being significantly higher. This implies that venture capitalists should take note of the risk profile in more depth when they examine deal propositions. While gearing as such did not emerge as a major reason for poor performance, other structuring related issues did and especially the relationship with equity share and ratchets. Subsequent interviews with both Team Leaders and venture capitalists indicated the negative features of ratchets in the creation of tensions and disputes between management and venture capitalist. Despite the evidence of such problems caused by ratchets, a considerable number of buy-ins still use ratchets. Venture capitalists require to consider alternative incentive systems.

There may of course have been incentives for venture capital executives to complete deals in the face of competition from other venture capital firms. This may have led to bidding up of management stakes and the use of excessively ratcheted structures. Reliance on renumeration through high fee income on deal completion may also result in adoption of financial structures which are not sufficiently robust in adverse economic and financial circumstances.

In the venture screening process considerable attention has to be paid to the type of managers. Cluster analysis showed that there were few significant differences across clusters in terms of performance, the discriminant analysis revealing the importance of teams where there had been strong personal knowledge of each other. Thus venture capitalists require to examine the formation of the team very carefully, and especially management's previous experience of each other. There was nothing to disprove the assumption that risks are likely to increase if the Team changes sector. Additionally the personal and commercial motivations of Teams have to be examined in depth.

Venture capitalists may also wish to review the type of company being purchased. Buy-in target companies are significantly more likely than buy-outs to have been privately owned rather than divestments. However one of the major findings of this Thesis is that it is these formerly privately companies which are most likely to be the poor performers with particular problems emanating from previous control structures and management vacuum following the departure of a strong entrepreneurial owner.

There was also considerable evidence that the due diligence process had not worked satisfactorily in many instances. Reasons for this failure may be varied but due diligence is a key part of the venture capital process. Venture capital firms may feel themselves under both cost and time pressures when carrying out due diligence, especially when there is competition from third parties to purchase the target or from rival venture capital firms to supply the Team's financial package. Venture capitalists must recognise the particular risk factors involved in buy-ins and be prepared to carry out particularly thorough due diligence investigatory work. This analysis must cover exhaustive and thorough testing of all main downside risks in management buy-ins- reliability of financial and accounting data, backgrounds and suitability of management, market characteristics, etc.

Areas where due diligence was seen to have been weak included trading performance in the period running up to completion with critical trends not being identified. There were cases where previous year's profits had been misrepresented with in particular bad debt positions and stock valuations being unrealistic. Fixed asset book values may not accurately reflect actual valuation on realisation.

Clearly venture capitalists had not looked exhaustively enough at the actual management teams in some cases. Extensive due diligence procedures require to be carried out in this area, even though diplomacy may be necessary.

There was also evidence from case studies that in many cases monitoring and control functions, which are as essential to the corporate restructuring framework as they are to the success of the buy-in, were not being consistently applied. While venture capitalists have an important role to play in using their experience, connections and resources to add value to their investee companies, they also require to be in a position of being able to react quickly should problems develop. While theoretically the type of governance employed in management buy-ins encourages this, there was evidence that in practice methods of monitoring and control were imperfect. Relationships had not developed to the extent that potential crises could be identified and understood by some venture capitalists. Reporting back through non-executives who did not work full time for the venture capitalist was frequently inefficient. Venture capitalists require to ensure that their control of investee companies is direct and current.

(c) Management Buy-in Teams

For management buy-in teams the main inference may be seen that buy-ins, although potentially providing significant personal financial gain, also imply risk. This risk may also be associated with the degree of personal leverage.

Management need to consider carefully the venture, their other Team members and their venture capital partner(s). They require a wide range of experience and must not be too influenced by the timing of a transaction, should this mean paying an excessive price.

Teams, somewhat unexpectedly, remained together to a similar extent to buy-outs despite the different types of pressure and stress. More detailed consideration however underlined the importance of the degree of personal knowledge that there was of team members at the time of the buy-in. Team Leaders should be aware of the difficulties in team selection when working in a different environment. In particular a buy-in which involves moving to a different geographical region, may result in particular strains and personal under-performance which are difficult to respond to. Additionally care requires to be taken over the size of the Team.

While entrepreneurial experience may be important in determining performance, it appears to be subordinate to sector involvement and previous working relationships within a team. This factor is particularly true of Team Leaders with previous buy-out experience. Teams must be aware that the buy-in is a different form which may not replicate the previous buy-out success especially if the team is incomplete, the target company is not known or the buy-out is in a different sector.

Target selection is of paramount importance as is being able to purchase the company at the right price. Management should be aware of the passive role of the venture capitalist in the search for a target company. Although personal knowledge is important in the target search, the need for thorough due diligence is essential. Significant industry knowledge should place the Team Leader in the position of being able to use personal networks to carry out informal checks on statements being used. Additionally there is the need to ensure that formal procedures are thoroughly carried out. Considerable effort has also to be made to ensure that the target company matches the abilities and ambitions of the management. Evidence indicated a not very sophisticated approach

in this area, yet it is one of the key features of the management buy-in. Both the venture capitalists and management have to adopt more efficient search methods.

Varying levels of support will be occasioned by different venture capitalists and it is important for managers to identify correctly the overall most appropriate venture capital firm. In this regard it may not be the institution which offers the most advantageous financial terms which will prove most valuable in the long term. A key element of this relationship will depend on the attitudes of both management and the venture capital firm to the realisation of the investment. In itself that may cause frictions and should be determined at the outset. While aggressive ratchets may help to reconcile differences between the two partners, in practice there appear to be considerable problems in achieving them. Management may therefore in the longer term be better to accept structures which are not so reliant on such instruments.

It is also important for management to realise that buy-ins are not static: they imply a high degree of change and management must be of the personality to be able to assess and implement necessary changes.

(d) Further Areas For Research

The Research carried out for this Thesis needs to be seen as being of a preliminary part of longer term investigatory work into management buy-ins. Limitations have been recognised in terms of the relatively short period that buy-ins have existed and the extremely unusual combination of economic and financial factors between the time of the survey and the end of 1992. Further research requires to be carried out to include areas such as: longer term performance as determined by accounting information; direct comparisons with management buy-outs; international aspects; public management buy-ins; venture capital returns; the use of second time entrepreneurs in management buy-ins; failure prediction; and venture capital screening and monitoring processes. These are described below:

1. Longer Term performance

Although this thesis has included evidence on the realisation of management buy-ins (both generally and in terms of the survey respondents) and initial direction of performance, detailed monitoring of medium and long term financial performance is required to assess the longer term impact and benefits of buy-ins. Comparisons using accounting data need to be drawn between pre and post buy-in performance both in terms of the company, the sector and other under-performing companies.

2. Comparisons of buy-ins with buy-out in simultaneous surveys

Significant differences have been perceived to exist between managerial, financial and performance aspects of buy-ins and buy-outs as well as the characteristics of their Team Leaders. The majority of buy-in managers could be seen as being opportunist, purchasing stakes in under-performing companies and subsequently initiating a high degree of change. A major problem, however, has been the lack of direct comparisons possible between the two forms over an identical time period with the same questions. Simultaneous surveys of buy-outs and buy-ins using questionnaires with a high degree of common questions would enable appropriate testing to confirm the differences which have been identified in this Thesis. Additionally indications of disappointing buy-in performance might usefully be examined in conjunction with evidence that acquisitions by corporate entities are frequently unsuccessful and lead to subsequent unbundling of a large proportion of assets acquired (Kaplan and Weisbach 1992, Ravenscraft and Scherer 1987).

3. International Aspects

Given the development of buy-ins in Europe, comparisons also require to be made on in international basis (see eg Clutterbuck, Snow, Robbie, Wright, 1991). Management buy-ins appear to have particular relevance for transfer of ownership in Eastern Europe during the privatisation process and also in West European countries where there may be considerable family business

transfer problems. In both cases the absence of available incumbent management possessing necessary managerial and entrepreneurial qualities may mean that corporate restructuring through a management buy-out is not feasible. There are however problems in finding and matching Teams and target companies as well as the possibility of resistance from insiders. It is suggested that a future survey could also involve an international comparison including countries such as the former East Germany and Italy. These could be linked to cultural theories of diversity between countries.

4. Public Management Buy-ins

A major problem encountered by the survey was the lack of response from 'public' management buy-ins. These frequently appear to involve buy-ins of a partial kind which are allied to significant turnaround aspects. Financial and accounting data on them are however available through systems such as Datastream. Closer examination of these on an empirical basis and comparison of other under-performing companies where ownership change did not take place could make a further contribution to the theory of corporate turnaround. The success (or otherwise) of quoted companies where there is a venture capital involvement would raise further interesting issues concerning the monitoring and structuring benefits perceived to be introduced by venture capital.

5. Returns on Venture Capital Investments

Further research is also warranted into the area of relative rates of return on venture capital investments and in particular those of buy-outs and buy-ins. As yet little research has been carried out in the UK partially because of slow progress towards common treatment of valuation of unquoted investments. Now that BVCA guidelines on valuation have been introduced, professional interest in this area and venture capital portfolios are more mature, such a study should have reasonable prospects of success.

6. The Role of Second Time Entrepreneurs in Management Buy-ins

Motivational and success aspects concerned with the manager from a successful buy-out or buy-in going on to a new venture capital backed project also merits attention. This sample has produced several Team Leaders who are second time entrepreneurs although the performance of some of the sample with such experience has been disappointing. Research is called for into the mode of selection of these entrepreneurs by the venture capitalist for follow on ventures.

7. Failure Prediction

The recessionary conditions of the early 1990's have resulted in both a much increased proportion of buy-outs and buy-ins failing and a significant number of buy-outs or buy-ins being from failed groups. These developments provide a useful base for more detailed study of both failure prediction and the role of management as an important cause of corporate failure.

8. Venture Capital Screening and Monitoring

The ways in which venture capitalists screen buy-in candidates and subsequently monitor their investee companies requires further research and consideration by the venture capitalists. By indicating that different types of entrepreneurs do not necessarily produce different operating results, existing venture capitalist preferences may not be correct. Previous entrepreneurship experience in particular appears to be considerably less important than seen in surveys of new ventures. Case study interviews also indicated that benefits to be derived from effective monitoring and participation which are essential ingredients of the corporate restructuring process were not always being derived.

15.4 Concluding Remarks

This thesis provides the first major insight into a recent area of corporate restructuring. The relative importance of management buy-ins can be seen in their growth to over 13 percent of the number of UK takeover transactions by 1992. While initial performance has appeared disappointing, the progress of buy-ins and the effect of their contribution to the regeneration of

individual companies must be seen in a longer term perspective. Turnround is a key element of many buy-ins but of necessity is a long process which can be badly distorted by the extreme economic and financial conditions of the past few years. Re-assessment of risks by venture capitalists, more active monitoring of their investee companies and increasing realisation of the differences with buy-outs gives them the opportunity to be more successful in the future.

The survey which formed the basis of the empirical section of this Thesis was limited by the relative youth of the buy-in market in that few buy-ins had been completed before 1986. While the interest shown in buy-ins in 1988/89 resulted in rapid expansion in the population of buy-ins, enabling an adequate sample for the survey questionnaire, it also resulted in a learning curve for the financing institutions. The relatively high failure rates encountered by buy-ins subsequently appears to have resulted in a reappraisal of investment in this form. Contraction in 1990 of the number of private buy-ins completed has been followed since mid 1991 by some recovery in activity which has been associated with lower entry prices and less highly geared structures (CMBOR 1993). In the current environment of more attractive corporate pricing, low interest rates and possibilities for economic recovery the prospects for a more successful future for recently completed buy-ins than for those in the survey are encouraging. The late 1980's buy-ins which have survived this far may themselves have prospects for profitable realisation.

Key long term questions about management buy-ins can only be assessed after a reasonable time period and consequently in the main remain to be answered. However the initial characteristics do show management buy-ins as a distinctive area of corporate restructuring. They also reflect both entrepreneurial aspects of the Team Leaders, strategic lessons from examination of turnaround situations, introduce significant equity incentives and debt bonding effects and encompass new governance systems.

Team leaders do emerge as more proactive and entrepreneurial than in management buy-outs. They are innovative in the extent and type of change which is introduced after buy-in. Although optimistic as to what they hope to achieve in their new independence, they do however find problems in gaining the performance improvements which had been forecast. Some of the reasons why theory indicates that performance improvements should be achieved are not seen to be valid-leverage or large management equity stakes or ratchet incentives do not necessarily produce the results which Jensen et al would have expected to obtain. However optimum levels of gearing and size may make the UK market very different from the US.

Management buy-ins appear relevant in the UK to the transfer of ownership in medium sized companies and using financing structures which do not involve excessive personal and corporate leverage. The systems of control offer a new type of governance which, when properly managed should produce a much more closely monitored and flexible system with above average performance.

While buy-ins are different from management buy-outs and can be seen to have particular risk factors, which may be more like those in general take-over transactions, their future success will depend on more careful analysis of general economic and financial trends, deal structuring and due diligence procedures. Risks can of course be reduced through the use of inside knowledge-eg by including key incumbent management in the Team where this is feasible and there is no great divergence in long term aims between the external and internal members of the Team whose personalities and abilities can be seen as compatible. This concept, as seen in the growing number of such hybrid 'bimbo' transactions, may help to increase the success rates of management buy-ins, allowing the more innovative external management to introduce necessary actions with effectively a much more satisfactory degree of target company knowledge.

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