PACIFIC COAST CAPITAL
INVESTMENT BANKERS

Writing a Business Plan for a Leveraged Buyout

T. James Herrmann

Writing a Business Plan for a Leveraged Buyout

By T. James Herrmann

T. James Herrmann is president of Pacific Coast Capital, a Larkspur, California, investment banking firm that specializes in private placement of capital for acquisitions and corporate expansion and also performs acquisition search programs. In its leveraged buyout business, Pacific Coast Capital focuses on companies with sales in the range of $20 million to $70 million. Mr. Herrmann *previously was associated with the Lawrence Corporate Finance Group in San Francisco and has been president of two middle-market companies. He has a B.S. in Metallurgical Engineering from Michigan State University and an M.B.A. from Harvard Business School.*

Despite the many recent articles and books published on the writing of business plans, we frequently see business plans for leveraged buyouts that are improperly prepared. One reason may be that most available business plan guides are oriented toward start-up or early-stage financings, in which the emphasis is placed on the product or the technology of the new venture. While these are not inconsequential items in a leveraged buyout, they are far less important than other aspects of a proposed transaction, such as the target company's historical financial performance, the management team's experience and the structure of the balance sheet that will result from the transaction.

An investor in an early-stage company looks to sales and earnings growth to achieve a return on investment. A buyout investor, on the other hand, looks initially to the use of financial leverage to achieve a satisfactory return. That return is then enhanced by the improved performance of the company. Lenders in a buyout, meanwhile, are equally concerned with both the quality of the assets and the company's cash flow.

This article provides a detailed outline for writing a buyout business plan. It differs from a business plan for an early-stage company primarily in that it emphasizes those factors that will be of most concern to investors and lenders in the marketplace for middle-sized leveraged buyouts. Let's go through the outline item by item.

Section I: Summary and Financing Request

Summary

This section should be viewed as an executive summary of the deal. It should contain the complete essence of the transaction, the information that would be communicated in a three-to-five minute oral presentation. Remember, this is like the beginning of any book. If the reader's interest isn't whetted at the beginning, he won't make it to the end. The summary should include the following topics:

The Company. Summarize its history and the significant events or major milestones in terms of the business ownership, management, products, customers and markets. Include a summary of the past five years of sales, gross profits and EBIT (earnings before interest and taxes).

Operations. This might better be called the summary of planned changes in operations. Briefly mention the planned changes and the impact they will have on financial performance. Include a summary of a five-year forecast of sales, EBIT and net income.

Management. A brief description of the management, which is a most important aspect of a buyout, deserves a place in the summary. Include a description of the backgrounds of the management team, and supplement this later, in the second section, with either a detailed paragraph or a resume of each individual. If the founders/buyers will be different from the manager currently running the business, describe the new roles and relationships.

Risks and Opportunities. A properly written business plan will present the company in a factual and objective fashion. This section can be used to overcome, or at least address, some of the obvious objections to the proposed transaction.

For example, if the company's plant is in a remote location, the lender will see a risk in using it for collateral. Should the company fail, liquidating the plant probably would be difficult. Such an objection might be overcome by including data about recent sales of nearby facilities, or about local companies that are expanding and in need of space. Another approach might be to point out benefits and opportunities the business enjoys because of its isolated location, such as reasonable labor costs or low worker turnover.

Obvious questions about the deal should be addressed in this section, even if there isn't an easy answer. Most lenders and investors know that they must take some risks and they want those risks to be identified.

Financing Request

Tied together with the summary above, the financing request quickly completes the picture of the proposed deal for the reader. It includes:

Structure of the Deal . This must include the price of the company, the terms of the transaction (whether it will involve, for example, cash, notes, preferred stock, royalty payments, etc.) and the amounts to be raised from all sources, including common stock, preferred stock, subordinated debentures, term debt and lines of credit.

Sources and Uses of Funds at Closing. Include a table describing all sources and uses of funds available for the closing. An example of a sources and uses table from an actual transaction appears with this article.

The "Sources" portion of the table includes two columns of figures, one indicating the total amounts available for the closing and showing the advance actually needed for the closing. The senior lender, based on the company's eligible accounts receivable and the lender's advance rate, made $1.660 million available for an accounts receivable line, but only $1.120 million was funded at closing, leaving a cushion for future working capital needs.

The uses portion of the table includes a line for "Transaction Fees". These are the fees and expenses such as legal, broker, accounting, appraisal, etc. incurred in putting the buyout together.

Collateral and Loan Values. For the secured lender, prepare a summary table of all collateral available at the closing. The table should include the loan values, advance rates and loan amounts.

An example of a table of collateral and loan values appears in this article. The accounts receivable loan is a revolving credit based on the actual amount of outstanding invoices. The inventory loan is a revolving credit that generally excludes work-in-process inventory. The equipment loan is a term loan based on the appraised orderly liquidation value (OLV), not the fair market value. However, the land and

Sources and Uses of Funds at Closing ($thousands)

Sources	**Advance**	**Available**
Cash in Company	$340	$340
Accounts Receivable Line	$1,120	$1,660
Inventory Line	$570	$570
Equipment Loan	$2,850	$2,850
Mezzanine Investor	$2,000	$2,000
Note to Seller	$1,000	$1,000
Founders' Investment	$500	$500
Total Sources	**$8,380**	**$8,920**
Uses		
Cash to Seller	$7,130	
Note to Seller	$1,000	
Transaction Fees	$250	
Total Uses	**$8,380**	

Collateral and Loan Values ($thousands)

	Book Value	Fair Market Value	Loan Value	Advance Rate	Available Loan Amount
Accounts Receivable	$2,060	$2,060	$1,950	85%	$1,660
Inventories	$1,610	$1,610	$1,040	55%	$570
Equipment	$1,880	$3,565	$3,565	80%	$2,850
Total	**$5,550**	**$7,235**	**$6,555**		**$5,080**

building loan is a term loan which is based on the appraised fair market value.

Section II: The Company

Industry

Start with an overview of the industry and the nature of the company's business. This helps the reader understand the business context in which the company operates.

Markets. Distinguish between the overall, general marketplace and the segment the company serves, whether it is a niche market or a regional market. When the general market has received negative publicity (as is often the case in mature industries, which offer some of the best candidates for leveraged buyouts), be sure to define the served market clearly. Identify both the positive and negative factors that influence the served market to provide a sense of the market's dynamics.

Market Trends. This is an extension of the discussion of markets. It should describe how the served market is changing in terms of its growth rate, pricing trends, product quality considerations, competition, cyclicality, obsolescence rates, etc. The business plan should relate these trends to the company's position in the marketplace.

Competition. This is one of the most important — and, surprisingly, one of the most frequently neglected — subjects in the presentation. One paragraph should be devoted to each direct competitor. The information should be concise, yet so detailed that each paragraph becomes, in effect, a "mini" business plan of that particular company. Each profile should cover the competitor's size, location, pricing strategy, market share, product quality, financial strength, etc.

It would be helpful to include here a matrix showing the candidate company and its competitors along one axis and the key elements that drive the business — such as sales volume, pricing points, quality levels, location, financial strength, sales strategies, etc. — along the other. In one glance, this would give a reader an overview of the industry and the buyout candidate's position within it. The matrix should be included here within the competition section, not in the exhibits.

Company History

This section should relate the history of the company's ownership, management, products, customers and markets. In general, the early history of an older business should be mentioned briefly, with more details added as the summary draws closer to the present.

Products

Describe products and services in terms of how they differ from what the competition offers. What are the price points? What are the benefits to the customer? Don't get too technical here; reserve technical information for an appendix. Include separate charts that show sales and gross margins by product line, both before and after the proposed buyout. This will demonstrate how planned changes in the product mix would affect performance.

Operations and Facilities

Include a general description of the company's plants and their locations, its equipment and its sales offices. Save the detailed descriptions of equipment, plants, land and buildings for the Description of Assets section below.

Operating, Selling and Marketing Plan

This may be broken into its separate subject areas, but, essentially, this section should describe the new owners' plans for the operations of the company. It should explain all planned changes, as well as aspects of the operation that will remain unchanged and why. The changes should be described in terms of their financial impact and related to the financial projections contained in the third section. A company break-even chart — showing sales volume on one axis and costs on the other — would be helpful to the reader here.

Management

This section may expand upon the relationships between the new owners and the former management. Include an organization chart and a paragraph or detailed resume on each of the key members of management. The resumes should be formatted in reverse chronological order, showing dates of employment, company, position and accomplishments in each job. Use a track-record approach that relates previous experience to the task at hand.

Description of Assets

A secured lender will want to know a lot about the assets being purchased, with particular emphasis on their value in a liquidation. This section should describe the following assets in detail:

Accounts Receivable. Include a summary of the receivables aging; a more detailed description can be provided as an appendix or upon request. Also, this section should cover terms, customers (include a list of major accounts), concentration of accounts, bad-debt experience, any receivables that have been dated, repurchase agreements, etc.

Inventory. This should include a description of inventories by the categories of finished goods, work-in-process and raw materials. It should describe their marketability in a distress sale.

Machinery and Equipment. A forced liquidation and an orderly liquidation appraisal is essential, but wait for a recommendation from the lender before paying for one. In the meantime, use management's estimates of the value.

Land and Buildings. It will be necessary to have both market value and liquidation value appraisals of these assets. It should also be obtained from an appraiser that your lender recommends, or one who has the general acceptance of many lenders. Put summaries of appraisals in the narrative; enclose the actual appraisals in an appendix.

Liabilities

Where appropriate, describe liabilities that the buy-out group would assume, such as payables, debt, contingent liabilities, product liability claims, etc.

Price of the Company

It is generally advisable to explain how the price of the company was determined. It may be based on other recent transactions, on price-to-free-cash-flow or other ratios, or on rules-of-thumb used to value companies in the industry. If payment terms are used, they should be translated into their present value using the discounted cash flow method, or their cash-equivalent value, taking into account the lower value that notes, preferred stock and royalties will have coming from a leveraged company.

Section III: Financial Review

Historical Financial Statements

The financial statements should include audited or reviewed annual income statements, balance sheets and cash flow statements for the last three to five years. Also include the most recent year-to-date statements. If the company's business is seasonal, a one-year cash flow statement should be included and should be broken out by month.

Forecasted Financial Performance

The forecasted financials should spell out in detail all assumptions that are built into them. Many of these assumptions will be based on the planned changes in operations described in the operating, selling and marketing plan contained in the second section.

These forecasted financials should include spreadsheets with income statements, balance sheets, and cash flow statements. There should be at least two sets of spreadsheets: One by month for one or two years, and one by year for five years.

Cash Flow Formats

Financial sources require realistic cash flow statements to help them decide whether they want to do the transaction. The best cash flow format for this purpose, therefore, is one showing receipts and disbursements, sometimes called the "checkbook" format. A format that shows sources and applications, including changes in balance sheet items, is acceptable but sometimes not as useful.

Sensitivity Analysis

Investors are bombarded by stacks of spreadsheet analyses filled with pie-in-the-sky numbers. Nevertheless, a leveraged buyout can lend itself to a reasonable and objective use of alternative scenarios. The business plan might include several runs (summaries only). Additional scenarios could be provided to specific lenders or investors upon request. Include a sensitivity matrix that along one axis shows critical assumptions, such as sales levels, interest rates, or the gross margin and along the other axis shows their impact on key financial results, such as profitability, cash flow, reduction of debt or coverage ratios.

Exhibits

Wherever possible, tables, graphs and other exhibits should be incorporated into the text. This way, the reader doesn't have to thumb back and forth between the text and an exhibits section at the back of the document. However, some exhibits don't lend themselves to such treatment and need to be placed in an exhibits section. Examples would be copies of the letter of intent, the secured debt proposal, appraisals and product literature.

Appendix

Prepare a separate appendix that financial sources with a strong interest in the project might use as reference material for a due diligence undertaking. This booklet might include a receivable aging, inventory listings, historical financial statements, patents, products or technical literature, market studies, magazine articles and annual reports of industry participants.

General Comments

In developing the business plan, remember the

BUSINESS PLAN OUTLINE
LEVERAGED BUYOUT

Section I: Summary and Financing Request
Summary
- The Company
- Operations
- Management
- Risks and Opportunities

Financing Request
- Structure of the Deal
- Sources and Uses of Funds at Closing
- Collateral and Loan Values

Section II: The Company
Industry
- Markets
- Market Trends
- Competition

Company History
Products
- Product Mix
- Profitability

Operations and Facilities
Operating, Selling and Marketing Plan
Management
- Organization Chart
- Resumes

Description of Assets
- Accounts Receivable
- Inventories
- Machinery and Equipment
- Land and Buildings

Liabilities
Price of the Company

Section III:Financial Review
Historical Financial Statements
- 3-5 years, audited or reviewed

Forecasted Financial Performance
- Assumptions
- Financial Statements, 2 years by month
- Financial Statements, 5 years by year

Sensitivity Analysis
Exhibits
Appendix

80/20 rule and be sure that 80% of the plan addresses the 20% of the issues that are of the greatest concern to the financial sources. Don't follow a long check list. Omit unimportant items.

Envision the plan as though it were a resume for a job search. Just as a good resume doesn't guarantee a job but might open the door for an interview, a business plan is, in effect, the preparation and script that might clear the way for a personal presentation that can raise the capital. Make your oral presentation parallel your plan.

When structuring your deal, keep in mind the issues created by laws governing fraudulent conveyance, equitable subordination, and environmental protection. Because of recent court decisions, lenders and investors are increasingly concerned about potential liabilities that could result from violations of these laws.

Bear in mind that, regardless of how well the plan is prepared, the most important element in any buyout is its proper structuring. This includes the purchase terms and the various layers of financing. Get help from an advisor with experience in leveraged buyouts.

Put plenty of equity and/or subordinated capital in the deal. Leveraging a healthy company puts it in trouble on day one. If it needs more capital for growth, the company takes a double whammy, and if the business requires seasonal lines, it takes a triple whammy. Equity and sub debt allow the business to operate with leverage and weather some storms.

PACIFIC COAST CAPITAL
INVESTMENT BANKERS

PACIFIC COAST CAPITAL 700 LARKSPUR LANDING CIRCLE, SUITE 199 LARKSPUR, CALIFORNIA 94939
Tel (415) 924-8260 Fax (415) 924-9263 www.pacific-coast-capital.com Tjherrmann@pacific-coast-capital.com