Buy-Out in Sleepy Hollow?

by Professor N. Branton

Author's Note: The editorial suggestion that the author write an article elaborating a speculation on the circumstances in which a management buy-out of a retail Co-oprative society might be considered and examining how it might be carried out received a less than rapturous welcome. However, editorial persuasiveness worked powerfully and possibly the writer was still under the influence of the Christmas spirit. He agreed to try his hand at an article. Here, for better or for worse, is the result.

Let us consider the following scenario. The Sleepy Hollow Co-operative Society has had a long and honourable history but is now rapidly heading for bankruptcy. It is located in a good market area composed of comfortably-off middle class customers. These are voicing increasing disenchantment with the quality of the service being provided and, at considerable inconvenience to themselves, are diverting more and more of their custom to the shops in the nearest town.

The root of the trouble is located in the Board of Directors, the members of which venerate the memory of the Rochdale Pioneers but whose views on retailing are of much the same vintage. The management team is good and contains one graduate of the Co-operative College and one from a well known University Business School. The members of the team have sound ideas for development and undoubtedly have the capacity to implement them. They have even made some progress in the face of continued opposition from the Board who have no room for "new fangled" ideas which require investment. The management team is wearying of the struggle, the patience of its members is running out and they are thinking of moving. If the team is broken up there is little question that the Society will go to the wall.

Option of a Management Buy-Out

There is a range of options to consider for checking the descent of the Society - accommodation within CWS or CRS, workers' Co-operative, buy-out by all the workers or a management buy-out. However, the management team favoured the last and one of its members, an assiduous reader of the Financial Times comes forward with a specific proposal.

He points out that the team knows what needs to be done to restore the situation and has the ability to do it provided that they are given a free hand to carry out their ideas. He suggests that they should organise a management buy-out and

reconstitute the Society as a private limited company under the Companies Act 1985.

The first objection raised by his associates is the problem of inducing the members of the Society to consent to its conversion to a capitalist enterprise. The answer is that many of their actual and potential customers in fact are not, and never have been, members of the Society.

Added to this, many members are disillusioned and are unlikely to raise any serious objections. In any case, the likelihood that unless some action is taken the area will lose the shopping facility altogether, should be a very persuasive argument.

Valuation - and Getting the Finance

The next objection related to finance. The members of the team pointed out that although they could with some difficulty themselves invest some money, collectively they could not contribute sufficient to acquire the assets of the Society and provide adequate working capital to give the venture a reasonable chance of success. In reply it was pointed out that if a well researched and comprehensive plan were drawn up, medium-long term finance for buy-out proposals was now available from a wide variety of institutions specialising in venture capital financing. Even the Big Four clearing banks were competing for this type of business. A common feature of buy-outs is that managers hold a substantial part of the equity having contributed a comparatively small amount of the total financial consideration.

It was pointed out that it would be advisable to obtain the consent of the members to the general idea before working out the details. If consent were forthcoming it would be necessary to value the business to be taken over. Since in the recent period the Society had not been very profitable, the net asset valuation method would appear to be the more appropriate. This would involve the market valuation of the assets less the liabilities. The precise values would depend on how close the society was to going into liquidation.

The really difficult part would be to produ convincing estimates of future revenue and expenses. These would have to be realistic. As the business was run down it would take time to build up and restore its earning power. Working capital would have to be provided to tide it over this difficult period. When "normality" was reached it would be necessary to convince the financial backers that the profits anticipated would generate sufficient cash flow to service borrowing and to pay for capital investment.

Loan of Members' Share of Purchase Price?

The financial arrangements with the outside investor would be considerably eased if the members of the society were prepared to allow their share of the purchase price to remain in the new company as a medium or long term loan at the appropriate market rate of interest, possibly carrying a right to convert into ordinary shares at some future date. This would allow them to participate in the profits. Moreover, since the market value of the assets of the Society had increased in monetary terms over the years, shareholding members would find this reflected in the value of their claims. This approach would involve no real sacrifice on their part and would certainly give confidence to the external financier. A further factor influencing his attitude would be the extent of the financial resources which the members of the management team themselves were prepared to commit.

If the venture proceeds according to plan it is hoped in the course of two or three years to obtain a quotation on the Third Market or possibly even on the Unlisted Securities Market of the International Stock Exchange. This would open up the possibility of obtaining a further injection of equity capital to reduce the capital gearing of the company and to provide finance for further development. Shareholding members would also then have a market for their shares should they wish to dispose of them.

The Decision of the Members?

Assuming that the plan is sufficently convincing to obtain the required outside financial supprt, it can be circulated to the members of the Society in the form of a printed document. This can be discussed in a meeting of the Society and eventually put to a vote. There will undoubtedly be strong dissent from those to whom the whole idea is anathema and who will denounce the treachery of the buy-out team for their abandonment of the principles of Co-operation. This despite the fact that, in reality, the members of the society have to all intents and purposes already abandoned them. In the view of the team a combination of realism and self interest on the part of the majority of the members will lead to its acceptance. This, in fact, proved to be the case.

The Prospects

The authors of the scheme do not subscribe to the view that the mere act of privatisation possesses magical powers to release the springs of enterprise by its mere introduction. It may, however, remove obstacles to enterprise such as, in this case, the inertia and lack of vision at the top level of the society. But the removal of such obtacles requires the presence of competent people to take full advantage of the new situation.

The members of the buy-out team must be firmly committed to the enterprise and fully aware that the success of the enterprise will depend on their efforts. They must have confidence in their ability to control the business and be prepared to accept personal risks. They must have the pertinacity to meet difficulties and obstacles which will undoubtedly occur both in the course of the negotiations and in the early years of the new enterprise.

The Author

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