

Entrepreneurship and management skills: the case of management buy-outs

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Abstract

The link between management buy-outs (MBOs) and the entrepreneurial process is analysed. It is maintained that a management-based explanation of entrepreneurial activity is an appropriate framework for analysing post-MBO performance. A sample of UK MBOs was studied and it was found that there was a general improvement in financial performance during the first two years post-MBO. There was also a significant improvement in the cash management of the new firms which suggests that MBOs do provide management with entrepreneurial opportunities which had previously been unavailable to them.

Introduction

A management buyout (MBO) occurs when a company is purchased by its incumbent management. The MBO may be regarded as providing the new management team with not only unexpected opportunities but also a change in circumstances, the key change being that the team members no longer fulfil the role of employee but are now the risk-takers. The managers become the providers of some, or all, of the capital.

There is no single definition of an entrepreneur, but a generally accepted starting point is to regard the entrepreneur as someone who perceives an opportunity and initiates actions in pursuit of that opportunity. That "someone" may be an individual or a group of individuals acting together. An MBO clearly falls within the latter interpretation since the opportunity being presented is that of becoming the new owner of a business.

The MBO also provides interesting insights into the ownership-control performance debate. Large firms tend to have a diffuse share ownership that, it is claimed, permits managerial discretion. One possible consequence of this is poorer performance. However, alternative models, for example the principal-agent model argue that adopting the appropriate internal monitoring mechanisms prevents discretion and boosts performance. For example, firms which had been the subject of successful take-over bids were more likely to be poor performers than non-targets [1].

This suggests that targets had implemented ineffective internal monitoring mechanisms. The MBO is one method of solving this potential problem by concentrating ownership within a small number of clearly defined groups.

This paper looks at the reasons behind MBOs and discusses how the concept of entrepreneurship is a helpful framework within which to analyse the MBO market. Information on 48 MBOs is used to assess the impact of the MBO on firm performance. A number of performance indicators are used which reflect the management's actions post-MBO, the points of comparison being the performance in the year of the MBO and two years after the MBO took place.

The Market for MBOs

An MBO involves the transfer of ownership such that the original owners now have either very little or no ownership of the newly formed company. Normally the management team provides part of the value of the purchase from their own personal funds. In some circumstances the MBO team provide all of the funds, in others significant shareholdings are taken by venture capitalists [2]. The presence of the venture capitalists or other financial institutions is important because the management team have to ensure an adequate return to those who helped fund the MBO. Thus they would be expected to provide effective monitoring of the management's actions.

The market for MBOs consists of three elements: companies willing to sell, management teams willing to buy and mechanisms for financing deals. In terms of the supply of companies available for MBO, the following are the main sources: first, buy-outs from independent companies in receivership; second, buy-outs from parent companies in receivership; third, buy-outs as a result of the retirement of the owner; fourth, buy-outs as part of the privatisation process. The government's policy of transferring assets from the public to the private sector has, on occasion, resulted in the incumbent management winning the right to manage the business, for example buses, freight and rail. Finally, buy-outs from parent companies by means of divestment. This is the most common source of MBOs and occurs for a variety of reasons, for example activities making insufficient profit, operations may be either loss making or only marginally profitable, assets may be sold to raise capital for projects perceived to be more profitable or the parent may wish to end producing specific goods or services. Divestment may also be undertaken as part of a parent's strategy of concentrating on its perceived core business because the parent's management believe they have the necessary expertise to achieve the firm's stated objectives. By concentrating on its core activities the parent may also overcome any control and monitoring problems which may be present as a consequence of managing a diversified company.

Entrepreneurs and Entrepreneurship

There is no single definition of the term "entrepreneur". However, an entrepreneur may be thought of someone who undertakes a variety of activities. For example an entrepreneur may start a business, change a business's direction, acquire a business or be involved in innovatory activity. Thus an entrepreneur may undertake a

range of different activities which have a common link - the perception of an opportunity and the willingness to do something to take advantage of it.

Explicit in this is that the entrepreneur is a risk-taker and has the opportunity to initiate and to implement decisions which deal with the uncertain business environment within which the firm operates. The business environment consists of many complex interrelated elements including: customers, competition, economic factors, social and demographic trends, government policy (both macroeconomic and microeconomic) and technology.

Cunningham and Lischeron [3] identify five frameworks within which to analyse entrepreneurial activity. First, the Intuitive school which stresses the personal psychological makeup of the individual; second, the Classical school which highlights the importance of recognising opportunities; third, the Leadership school which concentrates on a person's ability to motivate and direct people; fourth, the Management school which looks at the importance of organising businesses by such means as writing business plans, developing strategies and improved decision-making; fifth, the Intreprenurship school looks at innovation within organisations. MBOs, it is argued, may best be analysed within the Management school.

Within these schools of thought, the entrepreneur is responsible for identifying and meeting market needs. Entrepreneurs are often discussed in terms of starting a business. Osborne [4] identifies a number of strategies necessary for successful entrepreneurial start-ups which include identifying unmet demand, developing new products which meet changing market conditions, producing marketing and financial plans, weighing up risks and rewards and having the necessary resources to launch the business.

Although the emphasis is on start-ups, these strategies apply equally to MBOs. This is because, although trading has previously taken place, the business is effectively starting anew with a new set of owners and a different senior management team. The entrepreneurial process, illustrated in Figure 1, opens up continuous opportunities for entrepreneurial activity, notwithstanding the uncertain operating environment. Usually the process begins with the identification of a market niche, an innovation which requires the subsequent setting up of an appropriate organisational framework. If the business prospers, organisational development takes place in terms of strategies, structures, culture, products and performance.

In the context of an MBO, the entrepreneurial process may be thought of starting, not with the identification of a market niche, but with the organisational framework which is already in place. The decision to become a risk-taker and to operate in a competitive environment comes with the opportunity to be part of the MBO move from employee to owner. At the organisational framework stage of the process the entrepreneur is part of a team which offers the commitment necessary for the MBO to take place. Within the team, leaders will emerge but this again is part of the entrepreneurial process. An important element of this interpretation of entrepreneurship is the ability to manage resources effectively by, for example, developing business plans and identifying and implementing a coherent business

strategy. The freedom to act and the opportunity to undertake the role of decision maker is a major reason for the growth of MBO activity [5].

Entrepreneurship requires more than just the identification of new opportunities. Additional qualities such as imagination, commitment, decisiveness and self confidence are also important elements of the entrepreneurial process. Thus the entrepreneur introduces change into the market place but must also be aware of the outside pressures for change which are being experienced as the result of other entrepreneurial activity.

Management involved in an MBO must possess the characteristics outlined above if the MBO is to be successful. The MBO illustrates the freeing of the management from the constraints faced when operating within the parent's organisational framework. However, it must be stressed that if the MBO team do not exhibit entrepreneurial attributes, the success of the MBO may be called into question.

The Research

If MBOs are driven by entrepreneurial motives, we would expect post-MBO performance to be better than pre-MBO performance. This premise is supported by a number of UK studies. Wright and Coyne [5] found 38% of their sample of MBOs experienced substantial, steady growth in profits with 72% experiencing at least some improvement in profits. Similar significant improvements to profitability were found in other studies. Bannock [6] showed that 37% reported substantial increases in profitability with a further 29% experiencing a modest increase. Thus two thirds of the MBOs resulted in improved performance. Thompson, Wright and Robbie [7] found that 69% of their sample exhibited higher post-MBO profitability. In contrast two of the studies also found that quite large minorities of MBOs experienced reductions in profitability after the MBO, 24% [5] and 16% [6].

Thus, the evidence indicates that MBOs generally result in measurable improvements in performance. The overall result is consistent with the view that MBOs present entrepreneurial opportunities for the management involved and that they exhibit the determination and dedication to grasp the opportunities offered.

There are many possible explanations for the improved performance in the post-MBO period:-

- (i) increased expenditure on investment which may have suffered cut backs by the parent. This policy may have been the result of the parent's poor financial performance. Alternatively the parent may have regarded the division's operations as being outside its core business hence funding would have been squeezed. Given that the funding of MBOs tend to involve a substantial increase in debt, significant increases in investment spending are unlikely to occur in the immediate post-MBO period. Therefore it is more likely to be a longer term source of potential improvement in performance.
- (ii) new product development and innovation may also improve performance. However, given the timescales involved, this is again more likely to affect performance in the longer term.

- (iii) reductions in employment provide significant cost reductions which may be translated into higher profitability. This would have a rapid effect on performance.
- (iv) implementing policies which use the firm's assets more effectively, for example increasing asset turnover, would improve performance.
- (v) controlling payments and receipts more closely would ensure that the firm improves its revenue raising performance.

The Hypotheses

The general proposition being made is that MBOs provide entrepreneurial opportunities for management who had previously operated within organisations which had had an adverse effect on managerial decision-making. This leads to the following hypotheses based on expected improved performance post-MBO:-

H1 increase in creditor days - the firm will attempt to lengthen the time taken to pay its bills.

H2 decrease in debtor days - the firm will attempt to decrease the time taken to receive payment from their customers.

H3 maintain employment - it is not clear whether employment will increase or decrease. However, it is unlikely that the new management team are likely to attempt to introduce large-scale job cuts. Such an action would not send a positive signal to the workforce, a consideration important in a small business.

H4 maintain gearing ratio - if the MBO is funded by borrowing, gearing will increase. However, this represents an additional fixed cost on the firm hence there is an incentive to control such costs.

H5 increase the liquidity ratio - this indicates that the firm will ensure that it has sufficient cash to cover outgoings.

H6 increase sales - sales growth is often taken to show that business is improving.

H7 higher profit margins - increased profitability is another sign of improved performance. Given that small businesses are unlikely to exert any market power over prices, higher profit margins are a sign of more effective management.

H8 increased profit per employee - shows that the firm's resources are being utilised more efficiently.

The Data and Methodology

A sample of 48 private sector UK MBOs was collected from Acquisitions Monthly and Extel. Both provide lists of the names of firms involved in MBOs. The sample covered a wide range of sectors of the UK economy and covers MBOs which occurred during the period 1987-1993. Only MBOs which are defined as involving small firms was included, the definition of small being that used by the Bolton Committee [8]. This relates to firms which have fewer than 200 employees. Financial information was taken from the FAME, a database which provides details of the company accounts of public and private UK companies. A number of financial indicators were used to compare the performance at the time of the MBO with that of two years post-MBO. Data were collected on the following performance indicators:

(i) creditor days = $(\text{creditors}/\text{turnover}) \times 365$

(ii) debtor days = $(\text{debtors}/\text{turnover}) \times 365$

(iii) gearing = $((\text{long term liabilities} + \text{overdrafts}) / (\text{share capital} + \text{reserves})) * 100$

(iv) liquidity = $(\text{current assets} - \text{stock}) / \text{current liabilities}$

(v) profit margin = $(\text{profit before tax} / \text{turnover}) * 100$

(vi) profit per employee = $\text{profit before tax} / \text{employees}$

Results

Insert Table 1

Performance Indicators

Table 1 shows the performance situation two years post-MBO relative to the year of the MBO. In terms of the hypotheses, the results are mixed. The most clear cut results for them relate to H1, creditor days, H2, debtor days and H8, profit per employee. Contrary to expectations, only 39% of the firms increased the length of time taken to settle their debts with 61% paying more quickly. The shortening of the payment period may reflect pressure from suppliers who regard the new business's risk profile to have increased post-MBO. Consequently, they require more rapid payment. The perception of greater risk may come about as the result of the loss of financial power if the MBO involved a divestment. The fact that new businesses have high failure rates during their early years may also have persuaded suppliers to demand rapid payment. Alternatively, it may have been a deliberate decision by the new owners to promote good relations with their customers by offering prompt payment. Such a policy may also save significant amounts of money if it enables the firm to take advantage of any discounts available for early payment. Thus, although the result is contrary to expectations, it is still consistent with a management explanation of behaviour.

Given the more rapid payment policy, it is vital that the firms generate receipts more quickly by reducing the average collection period. 61% of firms cut their debtor days within two years of the MBO. Thus there is evidence of improved cash management which is critical for the survival of, particularly, small firms and is indicative of a greater awareness of the importance of appropriate financial management.

Further evidence of successful managerial action relates to the improvement in profit per employee. Given the relative importance of labour costs, a better managed firm would be aiming to increase profit per employee such that each worker was providing a greater contribution to performance. Within this context the fact that 48% of firms increased employment and 52% reduced it suggests that the improvement was not solely due to reductions in labour costs. However, the matter is not clear-cut. For example, of the firms which increased profit per employee, 61% reduced employment and only 39% increased employment. Thus there is some evidence that cutting labour costs improves profitability per employee. This suggests that the firm had not been properly managed previously but it has also been argued that a policy of large-scale redundancies is not conducive to creating a positive working atmosphere amongst the staff.

The results relating to liquidity and gearing provide some additional evidence of better financial management. Some 57% of firms increased their liquidity ratio which helps emphasize the importance of cash to a business. Only 45% of firms increased their gearing which underlines the importance of controlling costs in the early years of a business. This is consistent with a management view of entrepreneurship.

Further evidence of improved performance is indicated by the 67% of firms experiencing an increase in sales. In addition, 54% increased their profit margins. This is unlikely to be caused by increased market power given that the firms are small businesses. This suggests that better management had an important part to play in the improvement.

Insert Table 2

Table 2 provides a univariate analysis of the performance changes over the period in question. The results show that significant changes occurred in only three variables - debtor days (at the 1% level), creditor days (at the 10% level) and sales (at the 1% level). Thus in spite of the earlier results, there was no significant difference in post-MBO employment, gearing, liquidity, profit margins or profit per employee.

The increase in sales, however, is not as meaningful as it appears because the figures are in current prices and therefore ignore inflationary effects. If inflation is taken into account, the difference in sales became insignificant. Thus with the exception of better cash management, in terms of creditor and debtor days, there is no convincing evidence that post-MBO performance improved as a result of more committed management.

MBO Size and Performance

One of the key arguments behind the growth of MBOs is that it frees the new management from the stifling bureaucratic and institutional frameworks previously experienced. This is particularly true when an MBO follows divestment. Implicit in this is an assumption that smaller, more cohesive units are more likely to provide the necessary impetus to realise the available entrepreneurial opportunities. Thus the impact of size on the performance variables is an important issue in the assessment of the success of MBOs.

Insert Table 3

Table 3 shows the situation when the sample is split into four employment sub-categories. The size of the sub-samples makes it unrealistic to undertake significance testing, however the results do provide an indication of the relationship between MBO size and performance. If the bureaucracy argument is valid, and the vast majority of MBOs involved corporate divestments, we would expect the smaller MBOs to exhibit the greatest incidence of improved performance. However, few consistent patterns appear although it seems that the smallest firms experienced the greatest problems. For example, they had the lowest percentage achieving increasing sales, profit margin and profit per employee. The largest group were the most successful at decreasing debtor

days, increasing creditor days and increasing employment. However, their profit performance was not particularly impressive when compared to the other size categories. Indeed these results suggest that the middle sizes MBOs did best in terms of improved performance. Thus there appears to be a non-linear relationship between MBO size and better performance.

Conclusions

MBOs are an important element of the market for corporate control. They represent an opportunity for management to become risk takers by accepting a financial stake in the business. The MBO may also be seen as part of an entrepreneurial process which is triggered by the MBO itself. Thus MBOs conform more closely to the management idea of entrepreneurship as opposed to concepts based on innovative behaviour, personal drive or intuition. These types of entrepreneur are more likely to be associated with the conception and start-up phases of a business. The MBO, in contrast, involves a business which is already running but which requires, for example, better organisation and management which then provides the opportunity for innovation.

The results appear to provide evidence which supports the view that MBO activity is driven by the entrepreneurial process. The majority of firms experience increased profitability, with the incidence being more marked for the profit per employee measure. A less clear picture emerges when cash management changes are assessed. It had been expected that firms would increase the number of creditor days and decrease the number of debtor days. It has been shown, however, that debtor days were reduced as were creditor days. One explanation of the latter is that suppliers perceived the new firm to be a greater risk and so demanded earlier payment. Alternatively, the reduction may have been part of a strategy to improve relations with suppliers. Once this had been decided (or imposed), a reduction in debtor days becomes vital for effective cash management to be undertaken. This is borne out by the figures for liquidity and gearing which also indicate an increased awareness of potential short-term cash problems. The impact of MBOs on performance are less clear-cut when univariate analysis is undertaken. However, it still appears that there are significant changes to cash management policies.

The results therefore suggest that interpreting the entrepreneur as manager is a useful approach when investigating MBOs. The manager may be regarded as the vehicle for planning, for organising, accepting risks, and unlocking and creating value. Thus MBOs provide the mechanism whereby opportunity-seeking managers can change from undertaking purely management functions to fulfilling their entrepreneurial potential. The results suggest that MBOs are generally successful, at least in the short run. Therefore it appears that a great deal of managerial talent is not currently being used to its full potential. For example, large firms, which have numerous subsidiaries and operating divisions appear to be squeezing the initiative and drive of their staff. Thus divestment programmes are an important source, not only of realising the value of assets, but also of the freeing of entrepreneurial talent and drive.

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Table I Performance variables and entrepreneurial activity

Variable	Increase %	Decrease %
Creditor days	39	61
Debtor days	39	61
Employment	48	52
Gearing	45	55
Liquidity	57	43
Sales	67	33
Profit margin	54	46
Profit per employee	68	32

Table 2 Univariate analysis of the impact of MBOs on performance

Variable	Year of MBO	2 years post-MBO	t value	Significance level
Debtor days	73.75	58.37	2.94	0.006***
Creditor days	51.92	38.07	1.91	0.06*
Employment	99.30	104.90	-0.81	0.42
Gearing	313.84	193.12	1.18	0.25
Liquidity	1.69	1.35	0.48	0.64
Sales	£11.2m	£13.2m	-3.74	0.001***
Profit margin	9.85	11.29	-0.52	0.61
Profit per employee	£8844	£16956	-1.54	0.13

* p = 10%

*** p = 1%

Table 3 Performance and company size by employment

Variable	<50	50 -100	100-150	150-200
Creditor days				
- increase %	38	29	38	44
-decrease %	62	71	62	56
Debtor days				
- increase %	43	50	50	22
-decrease %	57	50	50	78
Employment				
- increase %	50	36	50	55
- decrease %	50	64	50	45
Gearing				
- increase %	67	22	75	10
-decrease %	33	78	25	90
Liquidity				
- increase %	58	75	38	60
- decrease %	42	25	62	40
Sales				
- increase %	46	82	75	80
- decrease %	54	18	25	20
profit margin				
- increase %	40	64	63	40
- decrease %	60	36	37	60
Profit per employee				
- increase %	56	82	75	60
- decrease %	44	18	25	40

Figure 1 MBOs and the Entrepreneurial Process

