The Benefits of an Owner Buy-Out For Digital Entrepreneurs

T

The recent announcement of the successful exit by French company Hospimedia from our Growth / LBO fund inspires me to make the case for a tool that remains little-known to digital entrepreneurs: **OBO or Owner Buy-Out.**

Naturally, those whose sole focus or ambition is a trade sale may wonder about the rewards of such an initiative. However, for hundreds of other entrepreneurs, an owner buy-out could be a remarkable step in their entrepreneurial career.

What are the basic features of an OBO transaction?

An OBO is a variation on the familiar LBO (Leveraged Buy-Out). It consists of buying out an entire company via a newly formed holding company, using i) a total or partial contribution (or roll-over) from the people who choose to continue the adventure (particularly founding managers), ii) leverage with little or no dilutive effect (bank debt, mezzanine financing, etc.), and iii) additional equity provided by a new financial investor (the sponsor).

It's easy to see that with the right framework, an owner buy-out can contribute to achieving a number of goals:

- Increase the capital interests of founding executives whose holdings may have been severely diluted in the past due to various venture capital rounds. An OBO is also the perfect tool for founding executives looking to take back majority ownership in the company they created.
- In addition, it allows founding executives to cash out part of their investment in a company in which they may have too much of their personal wealth. I must insist on the fact that, contrary to popular belief, a partial cash-out may be quite beneficial for entrepreneurs. Indeed, the ability to take risks tends to decline over the years, and such an initiative may reinvigorate entrepreneurial intrepidity.
- It allows traditional business angels or venture capital funds to exit under favourable financial conditions (often with no reps & warranties, or at least with no cash escrow– a word to the wise…)
- Moreover, it is clearly a unique opportunity for non-founding executives to take a stake in the company that they are helping to grow, and therefore to play a full-fledged role in future value creation.

However, an OBO is first and foremost an opportunity to take a fresh look at the company's strategy and lay out a 4 to 5-year growth plan that federates the different stakeholders.

Last but not least, an OBO often goes hand in hand with a management package implemented by the sponsor that aims to offer founding executives generous capital-based compensation in the event that the transaction exceeds its targets. To offer a concrete example, an LBO fund like the one I manage aims for lower returns (typically 2.5-3x) than my colleagues in the field of venture capital (10x): management packages can thus seem very attractive to executives, who are more likely to outperform at that level…

A common question: "who does an OBO apply to?"

Before exploring the obvious financial questions, it is essential to assess whether the founding executives and management team truly support such an initiative: they must be deeply convinced that the project could be a considerable source of value creation within four or five years, and that the time is not right to sell (even if some shareholders express a desire to exit). They must also demonstrate strong ambition and willingness to consider avenues for growth that have yet to be seriously explored (e.g. through acquisitions or international expansion).

For certain types of founding executives who have never had professional investors as shareholders in their companies, bringing in a fund like the one I manage may make a real difference in the fabric of the company regarding key subjects such as structuring, backing for external growth or, to mention just one more aspect, managing an exit process with optimal valuation.

That said, clearly we must ask ourselves if a given company is suited to an OBO. The literature on LBOs teaches us that a company's business must be stable and regular to generate predictable and relatively significant cash flows. The "L" in Leveraged reminds us that the debt has to be repaid…

Naturally, these same criteria must be met for a successful OBO, but in reality some may prove incompatible with the rather volatile nature of the digital market.

At ISAI, we have worked long and hard to adapt LBO practices to the specificities of the digital ecosystem, with an eye to helping pure players boasting strong growth carry out OBOs, even if they are not very profitable. One central notion is that the leverage in the case of an OBO in the digital sector can and must be structured differently than that of a classic LBO. In other words, value stems from growth rather than leverage: the ability to invest very quickly is essential in the event of rapid changes to the market. With that in mind, it becomes necessary to consider reduced leverage that would not drain cash flows (e.g. by using mezzanine financing with a bullet payment at maturity rather than amortized senior debt).

Don’t get me wrong: not all companies in the digital sector are cut out for a “growth” OBO. Nonetheless, our ecosystems would certainly do well to look more closely at this tool.

At ISAI, around half of the transactions in our Growth / LBO fund focus on growth OBOs. This was the case for Hospimedia in particular. There is no doubt that the OBO helped this small pure player write a remarkable growth story and prepare a strategic exit that would have been inconceivable a few years ago. The experience and security of a professional fund, its expertise in financing solutions and, in the case of ISAI, a unique understanding of the digital ecosystem thanks to its 130 entrepreneurs-LPs, can make all the difference.

In the end, an owner buy-out may not be suited to your case, but you have nothing to lose by asking yourself the question. Feel free to contact me at: martini@isai.fr