SELLING YOUR BUSINESS

GUIDE FOR OWNERS

PART ONE:

Introduction

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Preparing the Business for Sale

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INTRODUCTION

The sale of a business is usually a significant and in many cases life-changing event. Whether it is an entrepreneur realising his or her life's work or a corporate group divesting a non-core operation, it is not something which is undertaken lightly.

Selling a business is much more complicated and arduous than the uninitiated would think. Although some very small and simple businesses can be sold with a straightforward sale and purchase agreement, the sale of most businesses with turnover of £1 million or above is a highly complex exercise taking at least six months.

The complexity comes from the huge number of 'moving parts' – valuing the business, timing a sale, finding the right buyer, negotiating price and terms, going through due diligence and then actually concluding a sale, which in itself involves extensive legal and other negotiations.

To achieve a good result and come through a sale exercise unscathed takes detailed planning, a lot of work and, most importantly, the right advice. The purpose of this guide is to explain the process and set out some practical considerations for achieving the best possible sale of a business

Guidance on the role of advisers, regulatory requirements, taxation and issues around structuring of deals is outside the scope of this guide.

The guide also does not specifically address the distinctive points which can arise upon the sale of family-owned businesses, such as limited deal experience, limited management resource, continuity of management.

MAKING THE DECISION TO SELL AND TIMING

Reviewing the Alternatives

The first task for anyone considering a sale of a business is to determine their objectives, both financial and otherwise, and then determine whether those objectives are likely to be achieved by selling the business and whether the business is saleable at the right price and on terms that meet those objectives.

There are a number of different exit routes available. These include:

- A sale of 100% of the shares in the company to an outside acquirer – either trade or private equity;
- A sale to existing management or a buy-in team;
- A sale to employees;
- a partial sale of some of the equity; or
- a stock market flotation.

In many cases, not all of these options will be available. For example, a company may be too small or may not have a sufficient profit track record for a flotation or alternatively, market conditions may preclude it.

This guide does not cover the detailed regulatory requirements necessary to exit though a public listing. Although bear in mind that it would be exceptional to achieve a total exit immediately through an initial public offering.

As far as possible, the exit strategy chosen must fit with the needs of all interested parties, including members of the management team who are not shareholders of the business. It can be very helpful for the shareholders (and other interested parties such as management) to discus and document, in advance of the sale process, understandings on such as the minimum price expectation, preparedness to remain with the business following a sale, willingness to give warranties to the purchaser and the type of consideration which is acceptable. This can be an extremely useful exercise in flushing out issues prior to commencing the sale process. Disputes between vendor shareholders once the sale process is underway need to be avoided at all costs.

Reasons for Sale

The most frequent reason given for considering a sale is to realise capital, either for financial security or new projects. There is, however, rarely one reason alone, but generally a combination of the following:

- the recognition that the business has reached a premium value;
- the realisation that the business cannot grow without a significant capital injection;
- the need to access new markets by being part of a large, possibly international, group;
- the business has reached a size where the owner feels unable or unwilling to manage it;
- a disagreement among shareholders which means that the business is no longer manageable under existing ownership;
- the only alternatives are closure or sale by an administrator, receiver or liquidator;
- an imminent retirement / succession problem; or
- an approach has been received from a credible buyer or buyers of the business.

For a group of companies, possible reasons for the sale of a business including:

- the business may no longer fit within the group's core activities or future strategy;
- the business may have been a poor acquisition; or
- the group may have to sell because of liquidity problems.

External Factors

In addition to company specific factors, there are a number of external factors which may have a bearing on the optimal time to sell. These include:

- a bubble in the sector has resulted in high valuations, or there are concerns that a downturn is likely to arrive in the foreseeable future;
- the acquisition strategies of major players in the sector and/or consolidation patterns that may be emerging;
- changes in technology;
- the state of the economy and, in particular, the stage of the economic cycle;
- changes in market conditions;
- recent or impending legislation affecting the business; or
- the strength of the M&A market and the stock market.

It is important that a vendor not be coy about the reasons for sale. It will usually be one of the first questions asked by a potential purchaser and a reluctance to answer the question may make the purchaser suspicious.

Getting the timing right it is extremely difficult to pick the optimum time to sell a business. However, observing some general principles in timing a sale can be helpful. Timing is particularly important given the damaging consequences of an aborted sale process. The sale process often distracts management from running the business, which may adversely impact sales and profitability. In addition, if a business is placed on the market and then withdrawn, the business may gain a reputation for being permanently for sale, which can damage relationships with suppliers and customers as well as acting as a deterrent to future bidders.

Trading History
A purchaser will find a three year profit history much more convincing than a three year profit forecast. It is important to have a good profit track record to show potential purchasers.

Year End
Planning a sale exercise to complete shortly after a financial year end can be a good idea as it will allow the sale to be based on an audited set of accounts and will reduce uncertainty as to the profits on which the purchase price is based and the assets being sold. Furthermore, it means that the vendor is able to provide financial warranties to the purchaser based on a recently audited set of accounts.

Tax Relief
The current tax regime is always a relevant consideration in timing a disposal. This can be seen from the surge in company sales precipitated by the withdrawal of U.K capital gains tax (CGT) taper relief in April 2008.

Size
As a company grows in size, not only will it become more valuable by virtue of its growing revenue/profit stream but it will also generally be accorded a higher valuation multiple. The relationship can be primarily explained by two factors. First, as companies get bigger, more purchasers come into play. There is significantly less interest from private equity houses and particularly overseas trade buyers (which typically target market leaders or at least the no.2 in their sectors) in a company worth £5 million compared to one which is £50 million. Moreover, in general, the bigger the company the better its risk profile and earnings quality.

As companies grow in turnover and profitability, they will typically have less dependence on one or two key members of the management team, will have a better spread of customers and be less vulnerable to attack from competitors.

Market Conditions
Proprietors must consider the state of the M&A market in their sector. If there is a valuation bubble in a particular sector, characterised by exceptionally high profit multiples, a proprietor would be well advised to consider a sale at that time even if he had not otherwise planned on selling at that stage. The reason is that the valuation bubble will inevitably burst, such that even if the business's profits grow strongly in the aftermath, the proprietor may not achieve the same valuation for many years. This was seen in the dotcom bubble in the late 90s and subsequently in sectors such as nursing homes and renewable energy.

During a recession or downturn in M&A, transactions will generally be much more difficult to conclude, particularly where, as at the time of writing, there is a shortage of debt finance. This will also tend to have an inevitable effect on prices for most businesses. Exceptions can include strategically important acquisitions and trophy assets where price is not the main consideration.

In general, a recession will typically see a ‘flight to quality’, where purchasers will only acquire strong performers and sector leaders. Operations which are effectively underpinned by government spending, such as suppliers to local authorities, may also become relatively more attractive.

A downturn can also present significant opportunities, such as a more favourable property market for retail roll-outs. Businesses which are well placed to capitalise from these opportunities will be most likely to achieve premium prices. In more adverse market conditions vendors should consider whether it is appropriate to place a business on the market and discuss with their advisers the likely prices that could be achieved given the conditions. It may be preferable to ‘sit tight’, conserve cash and focus on preparing the business for sale when economic conditions are more favourable, although this could take some time – possibly several years.

M&A demand following a recession is often cyclical, with activity developing in particular sectors at different times, as they come out of a downturn. For example, consumer businesses tend to benefit more immediately from a consumer upswing than business services operations. The first few businesses placed on the market in a given sector will typically achieve a premium price due to their scarcity value and so it is important to be ready to move very quickly once the market is more favourable. Later, ‘me too’ sales can often be disappointing as the keenest bidders with an interest in a particular sector, whether trade buyers with a strategic need or private equity with an appetite for the sector, may have already made their acquisitions in that sector.

A downturn may also put pressure on businesses to shed non-core and/or loss-making operations, which therefore have to be placed on the market almost regardless of price. Similarly, businesses may have to sell part of their holding to refinance or secure funding to survive the downturn.

Sell when you don’t have to
The one overriding rule in timing the sale of a business is to always sell at a time when there is no absolute need to do so. Buyers will quickly sense a forced sale and use that knowledge to their advantage. History is littered with examples of vendors who left it too late, having often been in denial of the need for a sale.

Time Scale
In general, a sale exercise can be expected to take a minimum of six to nine months. This is only a rough guide. It can take considerably longer but will rarely be significantly shorter, save in the case of a distressed sale or a ‘rifle shot’ exercise involving only one purchaser. It can often take much longer if work is required on financial or operational matters to “prepare the business for sale”.

VALUATION

A valuation ahead of a sale will always be a theoretical exercise and the final valuation for the business is that which a willing purchaser is prepared to pay the vendor. A vendor will only really get a feel for what the valuation is likely to achieve when conversations are initiated with purchasers and the level of interest in the business determined. Prices of companies in common with other prices are largely determined by the laws of supply and demand. Nonetheless, a pre-sale valuation of a business can be an advisable component of the sales process.

There are several factors which will affect the value of a business, including:

- the company's historic and projected financial performance;
- the attractiveness of the sector in which the company operates and the strength of its market position;
- the size of the company;
- the strength of its management team; and
- the company's asset base.

During the course of negotiations with potential acquirers, a number of different valuation methodologies will be used to establish the range of prices within which to negotiate the sale. It is important for the adviser and the vendor to understand these methodologies and the issues that may arise.

Methods of Valuation
Although there are a number of methods for valuing a company, the following two are the most utilised by acquirers:

- multiple of the normalised earnings and turnover using multiples from comparable quoted companies and transactions (typically favoured by trade buyers); and
- discounted cash flows (used by private equity houses).

Multiple of normalised earnings
This valuation methodology applies an appropriate multiple to the normalised earnings to capitalise those earnings into a value for the business. Normalised earnings are a company's reported profits adjusted for abnormal or non-recurring items. Having established normalised earnings, the appropriate variant of earnings to multiples must be applied. The multiples normally applied are:

- earnings Before interest and Tax (EBiT)
- earnings Before interest, Tax, depreciation, Amortisation (EBITDA)

Care should be taken in selecting the appropriate earnings multiples to be applied, taking the following into consideration:

EBIT
Companies have different financial structures and therefore different interest costs and rates of taxation. The EBiT multiple is a pre-tax multiple and is considered by many to be a more appropriate multiple where a company has significant levels of debt.
EBITDA
In using an EBIT multiple, an assumption is being made that the depreciation charge for the year broadly equates to the company's capital expenditure for that year. This may not be the case, thus, the EBITDA multiple extends the EBIT assumptions to include differences due to financing arrangements for fixed assets and growth through acquisitions or organic growth by stripping out the effects of depreciation and amortisation.
PE Ratio
The PE ratio is the ratio of the market value of the equity of the company to its after-tax earnings. The PE ratio focuses directly on profits available to equity holders, but its drawback is that it does not reflect differences in gearing, depreciation and amortisation.

In some cases, it is advisable to use the different types of earnings multiples to act as a counter check to each other.

Turnover, gross profit and contribution

In addition to the above more commonly applied earnings multiples, where profits are very low or nonexistent, it may be appropriate to use multiples of gross profit, contribution or turnover. Turnover multiples may also be used preferentially in certain sectors, such as technology and Consumer brands, usually where there is huge growth potential relative to the size and profitability of the business for sale.

Comparable companies

The earnings multiples applied are typically based on multiples of quoted companies that, ideally, are comparable in terms of activities, size, geographical location and financial performance. The multiples of the comparator companies are derived from quoted public companies, since only quoted companies have valuations which are readily accessible and which have been established by the market. Once the comparable quoted public company multiples are identified, an appropriate discount should be applied if valuing a private company. On average UK private companies are sold at a discount to quoted public companies though the level of this discount has reduced in recent years. It may be appropriate to reduce the discount applied due to particular strengths of the business such as growth, profile, market share and size.

Comparable transactions

In conjunction with multiples of quoted public companies, it is also useful to utilise the exit multiples of recent completed transactions in the same sector as the company to give an indication of pricing and trends in its market.

Discounted Cash Flow (DCF)

The discounted cash flow methodology values a business by discounting the projected future free cash flows to the company, in order to arrive at a net present value (NPV) of those cash flows. The free cash flows are the residual cash amount after deducting all operating expenses, taxes and expenditures for maintenance of the business, but prior to deducting debt and equity financing payments.

The appropriate discount rate (or cost of capital) used to calculate the NPV will reflect the risks associated with the future cash flows. The discount rate is calculated by taking a weighted average cost of capital (WACC). The rationale for using a weighted average is that the assets of a business are financed through a combination of both debt and equity.

Estimating the costs of equity and debt are determined by reference to debt instruments and comparable quoted companies for which data is available. The higher the inherent risk of investment, the higher the required rate of return, and hence the discount rate, that will be applied. Care should be taken in drawing conclusions from this methodology, as this valuation is heavily reliant on the company’s financial projections and even small changes to the discount rate and other assumptions could have a material effect on the valuation. As with all valuations reliant on projections, the result is only as good as the assumptions made.

PREPARING A BUSINESS FOR SALE

To maximise the proceeds of a company sale it is essential to prepare the business for sale well before the actual sale process. A grooming exercise, which can take place over a few months or even years before a sale exercise, aims to enhance the attractiveness and value of the business to potential purchasers. This is achieved by measures such as:

- identifying potential purchasers early and positioning the company to attract them;
- raising the public profile of the company;
- maximising recurring profits by reducing or stopping non-recurring expenses including any proprietorial or non-business expenses;
- improving margins through cost saving measures;
- in the case of a subsidiary or division of a larger group, ensuring that it can operate on stand alone basis and possibly even running it autonomously for a period; and
- removing 'fat' from the balance sheet in the form of excess debtor or stock balances.

The more prepared the business is prior to the commencement of the sale process, the smoother, and usually more successful, the subsequent process will be. However, it is important not to groom a business for sale in an over-zealous fashion or attempt to boost profits in artificial ways which will be exposed during due diligence. This will back-fire on the vendor and may destroy a relationship of trust established between the vendor and the purchaser.

It is also necessary to commence the grooming process well before the sale process gets underway, principally because the impact of steps taken to enhance profits will take some time to flow through to the company's accounts.

A review of the business to determine appropriate pre sale grooming measures should cover the following areas:

Financial Matters

Review of costs

A review should be undertaken to identify and, possibly, eliminate all proprietorial and other costs which would not be incurred by an incoming purchaser. Examples of proprietorial costs would include relatives on the payroll, excessive travel and entertainment costs incurred by the proprietors and remuneration which exceeds accepted market norms. Whilst a purchaser might be persuaded that these costs should be added back to determine the company's underlying profit, the argument is always stronger if the business can be run for a period with these costs removed. There may also be costs which a buyer would not incur due to cost synergies and these should be clearly identified ahead of a sale.

Assets review

When a business has assets which may not be required or fully valued by a purchaser, such as surplus property or investments, removal before a sale exercise commences should be considered. In the lead up to a sale, working capital should be reduced to the minimum level required by the business. Policies concerning stock holding levels, debtors and creditors should therefore be reviewed at an early stage to ensure that there is no 'fat' in working

capital. If the company is sold with excess stocks or, due to poor credit collection, excess levels of debtors, the vendor is, in effect, gifting the excess working capital to the purchaser. Any such surplus should be eliminated and the resultant cash either stripped out or added to the purchase price.
Any hidden or undervalued assets of the business should also be identified. If the value of property assets is understated in the company's balance sheet relative to their market value they should be re-valued independently prior to a sale.

Tax review
All PAYE, VAT and corporate tax matters should be brought up to date and approved by the business's tax advisers. Any tax losses available to be carried forward or company tax benefits from an enterprise

Pension schemes
Final salary schemes can be very problematic in the context of a sale exercise due to the associated valuation issues. Consequently the vendor should discuss the impact of such schemes on a sale and the potential remedial actions with the advisers at the earliest opportunity

Management Review
The quality of the company's management team will generally be of paramount importance to a purchaser, especially where the senior management are proposing to leave the business at the time of, or shortly after, a sale. It is important to be able to demonstrate to the purchaser that there are competent second tier management available to assume executive control of the business following a sale. This will involve devolution of management control by the owners in the lead up to a sale. Where second line management are taking executive decisions, this should be documented. For evidential purposes, it may help to recognise their input formally by:

- minuting management meetings; and
- issuing formal job descriptions and promoting senior management to the Board

Accounting Policies Review
With a sale exercise in mind, a review should be undertaken of the following accounting policies, with a view to maximising stated earnings and balance sheet values while, at the same time, avoiding overly-aggressive policies that will lead to downward adjustments after due diligence:

- recognition of profit, particularly for contract related businesses;
- depreciation policies, both for tangible and intangible assets;
- provisions – excessive provisions against stock or debtors may be motivated by tax planning or an over-prudent approach and should be reviewed well ahead of a sale process, as a purchaser is likely to be sceptical of provisions released just before or during a sale exercise;
- valuations of properties and investments; and
- research and development – this may play a part in the purchaser's interest in the business.

Management Information and Budgets
it is advisable for the vendor to start preparing high-quality management accounts and put in place management information systems which track KPIs if they do not already do so. During a sale process, it is vital to have up to date information on the current trading performance of the company and the purchaser will be looking for the vendor to warrant a recent set of management accounts. It is equally important for the company to produce high-quality budgets. At a minimum, a purchaser will be looking for profit projections for both the current and the following financial year. In the case of financial buyers, a three year financial plan with detailed supporting assumptions will be required. If the company has not had a history of producing detailed budgets (and preferably beating them) any projections produced specifically for the sale exercise may lack credibility.

Legal Review
It may be sensible to consider a legal review, to be carried out in conjunction with the company's legal advisers. This would, at a minimum, ensure that:

- trading contracts are examined to ensure that no change of control restrictions or provisions apply. Such provisions (which e.g. allow the other party to terminate on a sale) are potentially 'poison pills' for a purchaser and to the extent possible should be resisted;
- intellectual property (iP) rights are registered. Where overseas;
- shareholder agreements and articles are examined to review provisions relating to a sale;
- where possible, any outstanding litigation is cleared up. even if it may be covered by insurance, major litigation can be a deterrent to a purchaser;
- to the extent possible, the ownership structure of the company is simplified. This may involve buying in minority or joint venture interests. Purchasers value simplicity and complex ownership structures can diminish the attractiveness of a business; and
- all leases, title deeds and other key contracts are located and reviewed.

Positioning
Well before a sale exercise is undertaken, the owner of a business should identify the purchasers or categories of purchasers most likely to be interested in acquiring it and position itself as an attractive acquisition target for those purchasers.

Corporate Strategy
Before making any strategic decision, a business proprietor needs to assess whether the decision would enhance or detract from value from a purchaser's perspective. This ranges from the fairly obvious such as not renewing a 20 year lease on the company's premises just prior to sale (as this might represent poison pill for a purchaser who want to consolidate the company's operations with its own) to more subtle positioning type issues such as whether diversifying the business into related activities will make the company more or less saleable.

Environmental Audit
Potential environmental liabilities will be a major area of concern for any purchaser. Depending on the nature of the business, it may be appropriate for the vendor to conduct an environmental audit prior to the sale to enable him to identify and remedy any potential problems at an early stage as environmental issues coming to light at a late stage in the process have the capacity to derail a sale exercise.

Data Room
Gathering information for a data room at an early stage can significantly speed up the subsequent process and is almost essential to a formal auction process. The contents and organisation of the data room are considered in the section on the sale process.

Vendor Due Diligence
Vendor due diligence involves the vendor instructing accountants to prepare a due diligence report on the business in advance of a sale exercise being undertaken. The report is then given to potential purchasers who have expressed serious interest in the company for use in finalising their offers for the business. The main purpose of vendor due diligence is to flush out financial, tax and other issues relating to the business at the outset of the sale process. As a result, the chances of the deal collapsing or the purchase price being reduced once heads of agreement have been reached or a preferred bidder chosen, are significantly reduced. It is unlikely that any material financial issues will arise from the purchaser's due diligence which had not already been identified in the vendor due diligence report. In addition, vendor due diligence can form a useful part of the grooming process to the extent it identifies issues which can be addressed before the sale exercise is initiated. In choosing a vendor due diligence provider, the vendor should consider the appropriate skills of the accounting firms able to provide the service and give consideration to whether using its own auditors / accountants / M&A advisers or an independent firm, is appropriate. A purchaser is less likely to accept a report it does not consider to be independent. The worst case scenario is for a vendor to incur this time and expense only for the bidder to ultimately commission its own report.

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