

Buying and Selling
a Family Business

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Introduction

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Establishing a family business that can be passed from one generation to the next may be the dream of the founder, but not necessarily that of later inheritors. Such family business succession requires willing and able younger generations, as well as careful planning.

Where succession is not viable, family business owners will need to find some other form of disposal. The good news for such vendors is that the market for buying and selling small firms is highly active. On average, each existing business has acquired one other firm in the past five years.¹ Figures reported in *Acquisitions Monthly* reveal a rising trend in

such transactions: 793 larger private companies were sold in 1990, and 1,039 in 1996. Average deal size had also increased, from £8.6m to £17.4m.

Sales to other companies within the same sector are the most common form of external disposal. This reflects acquirers' primary motivations of gaining market share and economies of scale, as well as desire for diversification into new products or markets and vertical integration.

Management buy-outs (MBO) and buy-ins (MBI) are also increasingly popular. According to figures from the Centre for Management Buy-

Out Research at the University of Nottingham, in the year 2000 the total value of UK MBO and MBI deals reached £23.4bn, the highest total ever recorded. The growth in MBO and MBI activity over the past ten years partly reflects the change in behaviour within family businesses and the lesser likelihood that succeeding generations will want to take over the business from their predecessors. Buy-out teams are potentially attractive purchasers, given their obvious knowledge of the company. In contrast, buy-in teams tend to rely on networks of venture capitalists and accountants to find their acquisitions. Having established

their competence in a particular industry and their ability to raise the cash, the team know that they will be kept on file as a ready-made buyer.

Despite the range of sale options, owner managers can find the prospect of selling their business a disturbing one. Professor Sue Birley of Imperial College has demonstrated how strongly issues related to the future continuity of the business feature on the entrepreneurial worry list.² Some 28% of her research sample said the issue of whether or not to sell the business was a fairly constant worry, while 22% admitted to having nightmares about selling. A

significant 27% worried about how they might find a buyer and 20% said the problem kept them awake at night.

Careful preparation can do much to lessen such fears. However, it may take several years to take a business from the decision to sell to the point where the business is ready for disposal. Ill-prepared vendors can find themselves being haggled down from their named starting price.

As for buyers, they too can fail to reap the benefits they anticipated when starting out on the purchase trail. Research shows that over half of all takeovers fail to achieve

the objectives of the buyers. Few takeovers allow the acquirer to generate an extra income stream immediately. Most require both time and effort and added investment from the purchaser. The sale and purchase transaction involves many decision points for both buyers and sellers. Both parties can choose to act independently, or through specialists such as business brokers and corporate finance boutiques. They may choose to rely on trade contacts or tap into business angel networks. They may decide to draw heavily on the technical expertise of lawyers and accountants, or do much of the groundwork themselves.

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For both vendors and purchasers, achieving a successful sale or purchase requires careful preparation and a considerable investment of management time. This guide examines the process of buying – or selling – an unlisted family business from the perspectives of both the acquirer and the vendor. It highlights key issues and options during the process, and aims to address some of the concerns that both parties may have.

NOTES

¹ Hughes, A. and Storey, D. (eds) (1994) *Finance and the Small Firm*, Routledge.

² Birley, Professor S. (2000) *Children and the Family Business, The PRIMA International Research Report*, Grant Thornton.

The decision to acquire or sell

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The first rule of making a successful acquisition is that there must be a sound commercial rationale for the deal. Many of the acquisitions of the 1980s were justified by the need for “diversification”; but in fact, this often meant that the Board had simply been tempted to make a takeover without having a real strategic or logical reason for the acquisition.

Why acquire?

Any business setting out to acquire another needs a clear vision of where it is going, why it wants to buy and where it will do so. Planning a deal should only begin once the strategy underpinning the

acquisition aim is established. There are many commercial reasons for an acquisition:

TO INCREASE MARKET SHARE

A business may wish to become one of the leading players in its market. Although this might appear to be too ambitious for many family firms, there may be opportunities in specialist sectors or in particular regions.

TO BROADEN THE RANGE OF PRODUCTS OR SERVICES AVAILABLE TO THE CLIENT

There may be obvious opportunities to boost sales by expanding into related activities. For example, an organic farm

provided an on-site point of sale for the public, and then acquired a restaurant that would make use of its produce.

TO ACHIEVE RAPID GROWTH

Acquiring a business may be quicker than building one from scratch, or may allow rapid expansion into an adjacent business segment.

TO ENTER OVERSEAS MARKETS

Acquiring an established overseas business may be cheaper than setting up a new branch, and will certainly build sales more quickly.

TO TURN AROUND A LOSS-MAKING BUSINESS

Acquiring an under-performing

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business can be appealing if the acquirer has the turnaround ability to transform poor results into significant profits. However, specialist skills are required and running an existing business well is no guarantee of success in a turnaround scenario.

TO BUY INTO A NEW TECHNOLOGY

This is a risky rationale. If the technology is unfamiliar, the chances are that the rest of the business is too.

TO INVEST SURPLUS FUNDS

This is an appropriate reason for an acquisition if the deal is itself consistent with the overall strategic

plan of the group. With a commercial rationale established, a decision may still be required as to the precise market sector to target for the acquisition. There may be a number of similar market segments, so which is best? The strategic plan needs to consider:

- the current state of the market
- future trends
- any factors which will affect the market, such as social or demographic changes
- competition
- skills issues
- new technology

Geography is also important in deciding where to expand. Does the

business lack presence in a particular region? Alternatively, a local acquisition may eliminate a competitor.

ALTERNATIVES TO ACQUISITION

When developing an acquisition strategy, it can be a useful exercise to consider the alternatives as well; these may be more straightforward than a full acquisition and involve less risk. These could include:

- opting for organic growth
- forming a joint venture or consortium
- taking a minority stake
- issuing distribution and manufacturing licenses

Choosing to merge with another business is also an alternative to a full acquisition. Legitimate reasons for considering a merger could be to achieve rapid expansion towards a stock market listing, to create a business with sufficient momentum to compete, or to overcome problems caused by a sudden death or illness. However, few mergers between private companies are successful. It is seldom possible to achieve agreement on valuations or on the equity share in the new business. ⁴Particularly detailed business planning is required to achieve a successful convergence of the two businesses.

WHY SELL?

There may be a number of compelling reasons for making a sale:

- forthcoming retirement
- a lack of suitable family members willing or able to run the business
- potential to take advantage of tax reliefs
- ill health
- loss of enjoyment
- increasing competition
- the business is becoming too big
- insolvency
- new regulations
- new technology
- falling demand
- disposal of non-core business

The need to sell may arise suddenly, or may be a result of months of deliberation conducted while the owner is under no pressure to sell. Either way, the primary concern for the vending entrepreneur must be to get a fair value to reinvest or to secure retirement.

Where possible, the vendor should try to make sure that the disposal is planned well in advance. This maximises potential sale options and potential buyers. If the decision is rushed, there is a risk that the most appropriate acquirer may never hear of the opportunity, or may be unable to act at that precise time.

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If options are restricted, available purchasers may be able to force down the transaction price.

Taking the decision to sell at an appropriate time is particularly important if the vendor suspects tough times ahead. An owner manager forced to sell because cashflow has deteriorated to the point where the business is unsustainable is unlikely to achieve more than a fire sale price. The pool of purchasers will be small and they will be concerned about the weakness of the business.

The vendor must be prepared for the sale to take some time, particularly if economic conditions

are unfavourable or if the industry is in recession. The time from the decision to sell to completing the sale may take years rather than months.

Finally, many businesses are sold because they receive an unsolicited approach from a buyer. Such offers must be considered with the same commercial sense as if the vendor had taken an unprompted decision to sell. If a sale is appropriate, the unsolicited offer may not itself deliver the best price for the business.

Alternatives to a sale

There are a number of alternatives to a straight sale of the business,

which may be worth considering. These could include:

HANDING OVER THE BUSINESS TO THE NEXT GENERATION

This requires a good succession plan which takes into account the needs and interests of all the generations in the family. The issues involved are discussed in a booklet which the ACCA helped to prepare, *Keeping it in the Family, SME Family Business Succession*.¹

SELLING TO OTHER EXISTING SHAREHOLDERS

Other shareholders may be able to buy out the party wishing to sell. One popular option is to make use

of self-administered pension schemes, where the funds of younger members of the family buy the older generation's shares. Unapproved benefit schemes provide an alternative route, lacking the revenue tax concessions, but offering great flexibility.

EMPLOYEE SHARE TRUSTS

The trust acquires the shares and distributes them to the employees, buying out the proprietor.

BUY-BACK OF SHARES OR SALE OF A MINORITY STAKE TO A THIRD PARTY

Both these options allow an individual to withdraw from the

business without forcing it to be sold. Sale of a minority stake may also be used to attract capital.

NOTE

¹ Fédération des Experts Comptables Européens and ACCA (2000) *Keeping it in the Family: SME Family Business Succession*.

CASE STUDY:

THE IMPORTANCE OF SETTING A REALISTIC ACQUISITION STRATEGY

Starphones was one of many mobile phone repair and service businesses established in the West Midlands in the early 1990s. The market was extremely competitive; while the demand for phones and services increased, so did the number of players in the market place. There were many operators, a large number existing only for a year to 18 months. No local firm was able to establish a particularly strong position or, indeed, was notably profitable.

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To “take the business forwards” in the face of very tough competition, Starphones decided to acquire Phones Are Us, with shops in the West Midlands and outside the region – in Shropshire and North Wales. The Directors believed that this acquisition would “combine strong service and retail networks”, while extending the core service business out of the West Midlands.

However, the acquisition did not deliver expected returns. The directors had failed to take account of the growth of digital technology, which undermined demand for the servicing of analogue phones. Having made an acquisition, the

business was reluctant to borrow to buy the equipment necessary to service digital phones. Already tight margins fell further. The problem was worsened by the inability to service digital phones bought from retailing outlets. Contract repairers proved unreliable and expensive.

The business went into receivership 18 months after completing the deal.expansion.

Preparing for the deal

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Preparation holds the key for both buyers and sellers. Cutting corners at this stage could lead to a poor buy or inability to add value after the acquisition for the purchaser, or a slow sale and disappointing price for the vendor.

PLANNING FOR AN ACQUISITION

The planning stage of an acquisition – picking the type of target and then moving to identify a business to bid for – is probably the most important stage of buying a business.

If a purchased business is going to fit into the acquirer's future strategy, the buyer must enter the

buying process with a clear profile of the sort of target company it requires. The profile should include details of:

- the broad characteristics of the target business
- the cash or other consideration available
- location and transport access
- any other key issues relevant to the acquisition strategy

Many businesses may have to be considered before a suitable one is found.

FUNDING ISSUES

Thought should be given to how any acquisition will be funded.

Assuming the acquirer does not have pots of cash to hand, bank credit can provide some finance. However, bank finance alone may well not be sufficient.

Private equity funding may also be an option. Venture capital firms and business angels (wealthy private individuals, often with extensive business experience) can provide funds in exchange for an equity stake in the business. However, such backers will need to be convinced of the commercial potential of the acquisition, particularly the opportunity to add value and grow the business.

Before entering into any such

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venture capital agreement, there also needs to be a thorough discussion between the acquirer and the backer about when and how the venture capitalist will want to exit from the deal. Many venture capital firms aim to realise their investments within three to five years. Does the business plan support such a timescale?

POST-ACQUISITION MANAGEMENT PLANS

Thought needs to be given to how an acquired business will be managed, right from the first assessment of the acquisition opportunity. Few businesses are sold at a bargain basement price and require the acquirer to add

value. Pre-acquisition planning should therefore identify how this might be achieved.

The acquirer should also be aware of certain legal issues that follow from the acquisition, such as the legal rights of staff. For example, European Directive 77/187, known as the Acquired Rights Directive, and the UK's Transfer of Undertakings (Protection of Employment) Regulations, known as TUPE, provide a certain amount of protection to employees in acquired businesses. Where TUPE applies, as in the sale of a business which is a going concern, many employee rights are automatically transferred to the

new employer, including terms and conditions of employment.

PLANNING FOR A SALE

Before seriously starting to look for potential acquirers, vendors need to spend some time grooming the business. The aim is to present the business in its best light, with profits on a healthy upward graph, in order to achieve the maximum sale price.

Any kinks in the financial picture need to be ironed out before the business goes on the market. This can mean reviewing accounting policies and generally trying to make the accounts as "clean" as possible. The process can take

considerable time. It is worth starting to think about such issues several years before the desired disposal date.

Business planning should be continued as though ownership will remain in the current owners' hands. This is the best way to continue generating profits and to demonstrate the future profitability of the business.

Particular issues to be considered include:

OUTSTANDING OPERATIONAL ISSUES

Any such issues, such as staffing constraints or customer and

supplier problems, should be resolved. The vendor needs to demonstrate a strong customer base and healthy supplier relationships.

CONTROL OR OTHER WEAKNESSES

The purchaser is likely to be concerned by failures to follow good practice. For example, irregular or poor financial information or weak credit control will certainly slow down the sale.

MATTERS RELATING TO PROVISIONS

These should be settled so that a problem can be eliminated or its true scale be allowed to crystallise.

If a business is to be valued on a profits multiple, eliminating large provisions should have a significant effect.

Some thought may also need to be given to precisely what is to be sold. Is it the entire business, or just parts of it? It may be necessary to review the present structure of ownership, since certain assets may be owned by individual shareholders for tax planning or historical reasons. There may also be charges on certain assets.

Settling these issues can take years rather than months. However, they should be

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addressed if the business is to be sold for its maximum price.

What issues can prevent a sale or acquisition?

There are a number of issues that can cause particular problems when trying to sell a business. Notable problem areas can include:

LITIGATION

Buyers will be wary of businesses in the midst of legal actions. For example, say a business is sold while in dispute with a customer over the applicability of a warranty. Under the sale agreement the final cost of the business to the

purchaser could be made contingent on the result of the dispute.

LIABILITY AND WARRANTY ISSUES

Purchasers are wary of exposing themselves to unlimited liabilities following an acquisition and will seek protection. For example, the purchase of an engineering business in the West of England collapsed when the buyer asked for massive warranties related to the possible costs of cleaning up contaminated land.

TAX PROBLEMS

Potential acquirers will be put off any business undergoing even a

routine investigation by the tax authorities, or even notified of an upcoming investigation. There is always the risk that the tax investigation could uncover problems that have to be addressed, for example, concerning director or staff benefits in kind.

COMPLIANCE ISSUES

There may be doubts about the capacity of a poorly managed business to meet regulatory requirements.

PLANNING PERMISSION ISSUES

If the deal requires new factory or office space to be built, doubts about planning permission being

granted could jeopardise the deal.

PENSION SCHEMES

If a company pension scheme has been set up for staff, the acquirer will be concerned about the extent of pension fund liabilities.

LOSS OF KEY STAFF

Certain personnel may be key to the current success of the business, as well as its performance in the immediate future. If such people are likely to leave on the sale of the business, and cannot be induced to stay at least for a pre-agreed short-term period, the acquirer may pull out of the acquisition.

ADVISERS

For a vendor, the sale of the business may hold the key to financing a comfortable retirement. For the acquirer, the acquisition may mark the start or development of a successful business career. For both parties, the transaction is a major one and should be undertaken with the assistance of skilled advisers.

Accountants with a specialist corporate finance focus (possibly a department within the company's current firm of auditors) can help value the business, making sure the vendor achieves a fair return and that the acquirer doesn't overpay. Accountants can also give advice

on grooming the business before the sale, making sure performance is at its peak and the accounting records are in good shape. A similar role may be performed by corporate finance boutiques, whose professional staff do nothing but negotiate the sale and acquisition of businesses.

Legal advice will be essential, for both the acquirer and the vendor, to make sure that deal terms, including any warranties and earn-outs, are acceptable.

Although each set of advisers will charge professional fees for their services, vendors should benefit from an improved sale price or

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deal terms, as well as reduced stress. The vendor should also be less distracted from the day-to-day running of the business. Acquirers should similarly benefit from the reduced risk that they might overpay for the business or find they have acquired a poor performer with hidden liabilities.

CASE STUDY:

LITIGATION THREAT SCUPPERS A SALE

Jim Smith built up a successful specialist springs manufacturing business. Over a number of years he created a core UK customer base and then expanded his sales to include the USA and Canada.

Having reached his late forties, Jim decided the time was right to realise the value he had created and began looking for a purchaser. There was considerable interest from companies in the UK and abroad and Jim was hopeful of a quick sale.

He then unexpectedly received a letter from the legal representatives of a significant US corporation who claimed an infringement of patents. Jim contacted his lawyers, who advised him that the claim had little substance to it. However, once the potential purchasers were informed, their interest immediately dried up.

Jim resigned himself to putting the sale on hold until the legal issues had been dealt with. His corporate finance advisers told him that no purchaser would pay a reasonable price for the business until the litigation threat had been resolved.

Finding a target vendor or purchaser

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The biggest problem most vendors face is the lack of an open market where bidders set prices competitively. The biggest problem faced by potential buyers is knowing when an opportunity to buy exists.

IDENTIFYING A BUSINESS FOR SALE

Finding a target can be the most difficult part of the process for a willing acquirer.

As a starting point, the completed profile for the target business needs to be converted into a shopping list. Although it may be easy to establish criteria if the business wishes to acquire a

known competitor, the process may take months or years as previously unknown targets are identified, researched, rejected or accepted.

A target should not be excluded from the list because it is known to be hostile to any acquisition attempt. Circumstances change and given 18 months, the business may desperately need an acquirer.

A number of resources are available to businesses seeking to identify suitable acquisition targets.

PERSONAL AND LOCAL BUSINESS NETWORKS

If the acquirer is looking to buy in the same sector or geographic area, a target may become known by informal means. This could happen where the owner wishes to retire. However, although such opportunities may appear highly attractive because of their ease of discovery, due diligence procedures must still be followed. Chambers of Commerce, Business Links or informal investment networks may also provide useful sources of information.

When following up a lead directly, it is worth noting that unsolicited letters generally have the same

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result as junk mail – they end up in the bin. Phone calls to the key decision maker tend to have a higher hit rate. However, unsolicited phone calls often work best if made by a professional adviser.

BUSINESS BROKERS

Brokers maintain a register of businesses for sale and can therefore be a useful source of opportunities.

This resource comes with a price, of course. Brokers generally charge a percentage of the purchase consideration from the acquirer, based on a sliding scale. The larger the deal, the smaller the

percentage. Fees are fully negotiable, however, and brokers will usually accept a deal that gives them a fee only on completion. Upfront fees are to be avoided. Acquirers should watch out for bad practices such as a refusal to disclose the full details of a target without an upfront fee.

DISPOSAL REGISTERS

Apart from business brokers, many accountancy firms also run disposal registers. A finder's fee will be payable on completion of the deal.

THE PRESS

A business for sale advertisement in the Financial Times typically

generates 50 to 150 responses. Such numbers make it difficult for the vendor to sort the wheat from the chaff; it is all too easy to select half a dozen bids from known or large businesses and to leave out interesting but unknown bids. Therefore a family business responding to an advertisement must argue its case persuasively and ensure that as many potential questions as possible are answered in the response.

It is also possible to put a business wanted advertisement in the press. However, many potential vendors are reluctant to disclose information to a box number, which may relate to a competitor.

If taking this route, the best way of achieving success is to use a reputable professional adviser and associate them with the advertisement. Potential vendors responding to the advertisement should be asked to respond by phone to the adviser.

VENTURE CAPITALISTS, MERCHANT BANKS AND CORPORATE FINANCE BOUTIQUES

Venture capitalists who have invested in a business usually want to realise their stake within three to five years and usually do so through a trade sale. However, while it is often the case that the

other partners in the business also want to sell, most venture capitalists are reluctant to disclose their partners' intentions.

Merchant banks and corporate finance houses are usually only going to be sources of targets for those seeking to acquire relatively large businesses.

ACQUISITION SEARCH

Specific searches can be done by finance houses, corporate finance boutiques or larger accountancy firms. This approach is probably the most effective method of all for finding a suitable acquisition, but it is also time-consuming and expensive. It is therefore probably

suitable only for the larger family firm seeking an acquisition.

SEARCHING FOR A BUYER

Vendors searching for buyers should probably aim to identify no more than six serious acquirers. These should have much to gain from the acquisition and be able to pay the required consideration, as well as being likely to develop the business and treat staff acceptably.

Target groups could include:

- overseas companies in the same sector, with interests in the UK but without a local operation
- UK companies with a product or service gap, or in the same

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broad sector but wishing to diversify

- businesses that wish to catch up with technology
- customers and suppliers
- a management buy-in or buy-out team
- direct competition – but treat with caution as they may only be after confidential business information.

WHERE TO LOOK

Vendors can consider the same sources as those available to acquirers. However, there are certain points to bear in mind.

Disposal registers may suggest that the business is not attractive

enough to be sold in any other way. However, registers run by accountants may have the benefit that advice may be available on the sale process, including pre-sale grooming.

Respondents to advertisements and business brokers must be tied in to respect confidentiality. Most brokers do not provide professional advice, although there are exceptions.

IS THE BUYER SERIOUS?

There is usually a vast spread between offers made for a business. Research shows that out of four offers, the highest will be at least 50% higher than the lowest.

However, the vendor needs to make sure that these are all serious offers and should try to obtain formal written bids, without entering into any exclusivity arrangements, before going down the aisle with one purchaser.

As mentioned above, an unsolicited approach on the doormat can be attractive, but should be treated with care because it:

- may not secure better value than keeping the business in the family
- may not secure better value than opening up the process through brokers or advisers able to attract a range of bids

- may be a time-wasting exercise if full commitment is not received from the potential buyer throughout the process. The proposed buyer may in fact only be trying to get hold of competitive information, may have no authority or may have no intention of offering amounts spoken about but not put on paper.

In short, it is essential to ensure that the offer is bona fide.

CASE STUDY: USING A BUSINESS BROKER

An established London-based business broker deals with companies with a net worth between £1m and £25m, although primarily £5m or less. Its objective is as follows: “To meet the need of owners of private businesses to find a better way of achieving a confidential sale at the best possible price.”

The broker seeks to do this by the effective use of the network of accountants, lawyers and actuaries that it has developed. The firms within this professional network all feed vendors and purchasers into

the broker’s marketplace, performing a form of screening so that only serious vendors and buyers make it through. The broker’s experience shows the value of such screening: between 80% and 90% of vendors who approach the broker directly are rejected because their businesses do not support the prices they seek.

Once a business for sale is referred to the broker, a dedicated team of staff conduct an in-depth study of the business with the proprietor to develop a strategy and prepare a sales document. An initial anonymous sales notice is circulated by the network’s

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member firms and the broker then chooses the half dozen or so of the best suited bidders who respond. The broker provides a discreet marketplace, with the bidders never knowing the name of their potential target until they have put themselves firmly in the market to buy. It is up to them to make offers, in competition with an unknown number of rivals. The broker's staff guide the vendor through the process of negotiation with the potential buyers, typically achieving a higher price than any earlier offer received through a direct approach.

One of the major benefits of the broker's in-depth research is that it

can identify companies that are the right fit: a good fit means a higher price. Another benefit is that the risk of a post-sale dispute and subsequent litigation is minimised. The broker's approach appears to be successful. Having come to the broker, one loss-making publishing house was sold to the same publisher it had previously approached directly for a sum several times the original bid. that the risk of a post-sale dispute and subsequent litigation is minimised.

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previously approached directly for a sum several times the original bid.

Broking the deal

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There are effectively two stages to completing the sale or purchase transaction:

- an initial investigation in which both sides size each other up and decide if they want to proceed further
- due diligence, in which the acquirer formally examines the target in detail to ensure it knows fully what it is taking on

The parties – for even the smallest acquisition – would be well advised to follow the same two-stage process. However, due diligence is expensive whatever the size of the businesses involved and should commence only after the

Heads of Agreement have been signed.

THE INITIAL INVESTIGATION

Exploratory meetings allow the purchaser and vendor to form an initial view of the other party. The vendor should require confidentiality throughout the process, even during this initial investigation stage. To preserve confidentiality, these meetings should be held offsite.

An initial meeting should be arranged to sort out the broad format of the deal, to allow issues to be aired and to create trust. Both sides need to remember that there is no right price for a

business and many of the issues are matters of highly subjective judgement.

The vendor should aim to find out as much as possible about the purchaser to assess the strengths of the bid. At the same time, the vendor will want to emphasise the opportunities available.

Many vendors would rather sell at a lower price to the purchaser who appears most able to sign and seal a deal with the least delay and difficulty. Therefore, the purchaser needs to present a strong case, as several other bidders may still be in the field. Perhaps the best way

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to do this is to involve contacts from previous acquisitions, particularly former vendors who can speak for the purchaser.

As far as the acquirer is concerned, the initial investigation should aim to establish the potential of the business, identify any sensitive issues and assess potential problems and risks, such as senior staff who may leave after an acquisition.

The acquirer should probably conduct these investigations using an in-house team, led by the individuals who will be responsible for the business post-acquisition. An outside adviser should probably also be included.

An investigation checklist should be compiled covering the considerable financial information and broader business information required. It should include:

- the history of the business
- business details, such as all trading locations
- assets
- liabilities
- staff
- directors' details

Both sides may need to give particular attention to a number of issues, such as:

EXACTLY WHAT IS BEING SOLD

Part of the business may be

unattractive to the purchaser. The purchaser may simply want to buy the assets of the business to avoid tax liabilities or legal disputes. A business property may be owned by an individual, rather than the business, and it may be necessary to negotiate a separate purchase or lease.

EARN-OUT FEATURES

An earn-out, where total consideration is dependent on performance over a period of years, may suit both sides as a way of meeting the price expectation of the vendor while protecting the purchaser. Both sides may tie it to high or low cashflow projections used as part

of the negotiating process, the purchaser making higher payments if higher profits are generated. For the purchaser, it may also be used to tie elements of existing management to the business. Earn-outs are particularly common in service businesses where there are few tangible assets. However, they frequently lead to messy negotiations and, if definitions of future profits are not watertight, may end up in dispute. The vendors will usually continue to provide most of the senior management during the earn-out period, but operating procedures for the newly acquired business will need to be agreed in detail between the two parties.

ANY ASSETS RETAINED

What happens to the outgoing owners' toys, such as the racehorse?

HOW THE BUSINESS WILL BE MANAGED

Where the acquirer needs continuity of management, an earn-out may help to achieve this. Otherwise a commitment should be obtained from directors to stay with the business for an agreed period. Acquirers should be warned that offering a service contract may not be a good idea, since they may subsequently be forced to remove a poorly performing director who will then receive payment under the service contract.

WARRANTIES AND CONDITIONS

Warranties may be required if profits fall significantly short of the vendor's projections.

PRICE

Initial negotiations will allow a broad price range to be agreed. The process of establishing the value of a business for sale is considered in more detail in section 6.

Follow-up meetings may be used to question assumptions and calculations made in information supplied by the vendor. However, the vendor will want to limit the time involved in this process in order to push the purchaser

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speedily to the Heads of Agreement stage.

HEADS OF AGREEMENT

The meeting to negotiate the Heads of Agreement will make or break the deal. The meeting could last from three to twelve hours.

A team leader should be chosen to head up each negotiating side.

This could be the manager who will run the acquisition, the best negotiator on the vendor's side or a professional adviser. It may be better to let the most senior team member sit in the background to intervene when necessary.

A pre-meeting should establish roles and tactics. The meeting

itself needs to be conducted in a calm and businesslike fashion, with a measured approach and an emphasis on listening. Heads of Agreement meetings are often portrayed as pits of conflict, but this is to be avoided if both sides wish to reach a successful deal.

The first part of the meeting will involve both parties agreeing and combining their draft agendas. The major agenda items will be:

- settlement of outstanding issues from the last meeting
- confirmation of assets or the business to be purchased
- personal asset purchases
- asset leases

- pension funds
- personal guarantees
- warranties and conditions
- service contracts for directors
- earn-outs
- price
- timetable

The settlement of price comes last, as it can be fairly agreed only once the other agenda items have been dealt with.

Where the deal involves existing shareholders buying out other shareholders – or one family member buying out another one – there may also be consideration of so-called non-embarrassment clauses. These are most likely in a sale involving a

medium-sized or large family business. These clauses seek to protect the vendor from the embarrassment of selling at too low a price, only for the acquiring family member to quickly sell on the business at an increased price. The non-embarrassment clause gives the original vendor a right to a share in the uplift – the increased sale proceeds – resulting from any onward sale within an agreed timescale. The timetable needs to be approached in some detail. A written and structured timetable allows both sides to identify where slippage is occurring as the sale proceeds. Among other matters it must include:

- the date when the Heads of Agreement will be signed – ideally within a day or two of the drafting meeting, and not at 3 a.m. at the end of the meeting
- when due diligence will take place and when reports will be made to the acquirer. This will need to be done with discretion, otherwise the staff will realise that disposal is imminent.
- when the draft legal agreement will be received by the vendor from the purchaser and when a response will be made
- when the disclosure letter will be received. This flushes out information that may otherwise be held back by vendors, such

as violated warranties. Very broad sweeping clauses may be used by a vendor to undermine clauses in the agreement and care should be taken to reject such clauses. The acquirer will have to accept or reject the statements in the letter

- when formal board approval will be given for the acquisition: otherwise a floating board meeting may be used to try to force a last-minute reduction of the offer
- when the legal documentation will be finalised
- the date of legal completion

Usually, the outstanding points in a sale and purchase agreement are

Broking the deal (continued)

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best dealt with at a one-off meeting at which both the principals and their advisers are present. This minimises delay by lawyers and obstinate vendors or purchasers. Unless particularly significant issues are outstanding, the prospect of an all-night meeting can focus minds towards an efficient and reasonable agreement.

DUE DILIGENCE

Once the Heads of Agreement have been signed, due diligence tests the strength of the understandings on which an offer is made.

The process will involve a highly detailed check on any matter that might impinge on the value of an offer and the success of the business after acquisition. Finance, tax and legal issues are particularly important and may require specialist advice, although commercial issues need to be examined as an equal priority. For example, if the business being acquired claims to have a certain market share, the acquirer should not simply accept such assertions to be true. Nor should the acquirer accept at face value claims that the business provides the best service in the local market. Market research should be conducted to test such claims, if they are

considered vital to the acquisition rationale or the business valuation. The due diligence process would typically include verification of freehold property ownership, leaseholds, conditions applicable to outstanding liabilities, rights to intellectual property and material contracts. While a contract may contain a series of protective warranties, it is far easier for the acquirer to identify a problem at the due diligence stage rather than having to sue after the event.

The due diligence is usually managed by the acquirer's solicitors and auditors. Both the acquirer and the auditors need to be happy that they are competent

to engage in this process. Information may be requested from the vendor in the form of an extensive questionnaire. In order to make the due diligence process flow as smoothly as possible, the vendor can prepare much of the information in advance, ensuring that all records are complete and that no documents are missing. Having to obtain copies of contracts or royalty agreements from third parties once the due diligence is underway can be highly time-consuming.

CASE STUDY: AGREEING AN EARN-OUT

Candine Ltd was a small cleaning company trading profitably in Aberdeen. Blue Line Ltd had a strong presence in the West of Scotland, but wanted to expand. Initial negotiations set a cashflow valuation of £1.2 m on Candine.

Due diligence revealed that 38% of Candine's revenue came from cleaning contracts with a number of education authorities. The further delegation of school budgets meant that individual schools would now be putting out cleaning contracts, threatening a large chunk of Candine's income.

The final deal kept to the £1.2 m valuation but deferred £400,000 of the consideration for 14 months and the balance for a further year, while agreeing that, should profits be increased by 10% or more, a further £100,000 would be payable at the end of the earn-out period.

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Valuing the business

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Agreeing on the value of the business inevitably involves detailed negotiation between the vendor and the acquirer. The foundation of any valuation will be a series of calculations of profits and cashflows, assets and liabilities, although many less quantifiable factors also come into play.

When considering past profits and cashflow information, any events that have distorted performance over preceding years need to be discovered and accounted for. The acquirer should also be on the look-out for profit manipulation as a result of unusual accounting policies.

Both purchaser and vendor will

prepare adjusted accounts which try to project how the business would look under new ownership, taking account of factors such as:

- changes in staffing
- pension adjustments
- savings due to increased purchasing power
- rationalisation of premises
- the elimination of one-off boosts or reductions in profits which are unlikely to happen again
- current market prices of assets

Similarly, cashflow projections will take into account any advantages obtained by a purchaser, for instance by the sale of assets, as well as any additional costs faced, such as the

need to refurbish premises.

Other less tangible factors should also be considered, such as high-quality staff, strong distribution networks or the opportunity for synergy between the two businesses.

SETTING A VALUATION

Several quantitative techniques can be used for establishing an initial valuation of the business. This value can form the basis for negotiations that then take into account the non-quantifiable or less tangible elements.

RETURN ON INVESTMENT (ROI)

This is a simple method for calculating the value of a business,

based on the return on investment that the acquirer wants to achieve, using the following formula:

$$\text{Percentage ROI} = \frac{\text{Pre-tax profit}}{\text{Net cash invested}}$$

The first step for the acquirer is to decide on the acceptable rate of return. As a simple example, say the purchaser wants to achieve a return of 20% in the second year after the acquisition and that the pre-tax profit forecast for that year is £1m.

Plugging these numbers into the equation above gives a figure for net cash invested of £5m.

This is not necessarily the price paid for the business, however. Expected cash generated until the end of year

two, as well as any earn-out payments, need to be taken into account. Say cash generated in the current year and the first year after the deal totals £0.8m, but the vendor receives an earn-out payment of £0.6m in the second year.

$$\text{Net cash invested} = \text{Purchase price} + \text{Earn-out} - \text{Cash generated}$$

In the example above, a purchase price of £5.2m would generate the desired return of 20%, based on the forecast profits, cashflow and earn-out. This method has the great advantage of being simple, but it relies on forecasts, which are inherently uncertain.

DISCOUNTED CASH FLOW

A discounted cashflow calculation is the most comprehensive and relevant way of valuing a small business. It can be used to give a net present value (NPV) – the present or current value of the cashflows generated by the business from now until a predetermined future date. Future cashflows are discounted back to the current date using a stated discount rate. The method involves estimating cashflows – inflows and outflows – over a number of years ahead. These should include the initial purchase consideration as well as any later earn-out payments, cashflow resulting from business operations (including

Valuing the business (continued)

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capital expenditure), tax payments and the realisable value of assets in the business at the end of the period.

A major advantage of the technique is that the cashflow projections can be adjusted to take account of uncertainties, such as the value of a contract currently being negotiated. In other words, the method can be used to make extensive “what if” projections, giving a range of business valuations depending on the assumptions made. However, the key disadvantage of the NPV method is its reliance on increasingly subjective sets of information as the cashflow

projection extends further into the future.

EARNINGS MULTIPLES

This is a highly popular method amongst small firms.

Unfortunately, it is also unreliable because recent and current profit performances may be erratic and unrepresentative of the potential of the business. However, the method is easily understood. The earnings multiple is usually based on the Price/Earnings (P/E) ratios of listed companies in the same sector. These are calculated as follows:

E ratio =
present market share price ÷
historical earnings per share

The P/Es of listed companies are then discounted before being applied to private companies, reflecting factors such as the difference in share liquidity. Smaller, private companies are almost always sold at a lower multiple. The key challenge is to set that multiple, although a discount of 30% to 40% is normal.

ASSET BACKING

Profits and cashflows are generally most relevant for setting business valuations. However, net asset backing will be an important element of the calculation for businesses that are not performing, but which have strong

asset bases. It also applies where assets would achieve significant returns if sold on the open market.

For example, consider a business which is generating moderate profits and recently invested heavily in fixed assets. A valuation based on profits and cashflow could return a value less than the net tangible assets contained in the business. The vendor should stress the asset values during negotiations in order to achieve a price greater than the net asset value. Alternatively, the vendor could consider extracting value by selling selected assets before initiating the sale of the business.

CASE STUDY:

GETTING THE PRICE RIGHT – OR WRONG

Peter Toplis had investigated selling the small packaging business in which he owned a half share. Not being sure where to start, he advertised in the trade press. “I advertised, but when my main competitor said she was interested, I wondered if she just wanted a look at my business,” Peter says. “How right I was – the offer was derisory.” Disillusioned, Peter abandoned his immediate attempt to sell.

Two years later Peter found that his partner wanted to leave

because his doctor had lined him up for a quadruple by-pass. In fact, both men now found the prospect of retirement alluring. Aged 64, Peter did not fancy running the business himself. Neither partner had family members who were interested in the business.

The question was, how were they going to get a price that reflected a reasonable return on their investment? Without taking professional advice, Peter advertised again and received three offers. He finally accepted £750,000. Four months later the business was sold on for £1.2 m.

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Management buy-outs and buy-ins

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Management buy-outs (MBOs) are increasingly common and, together with buy-ins (MBIs), represent the most frequent application of venture capital in the UK.

MBOS

An MBO has certain attractions. The management team will clearly have an intimate knowledge of the business. This means that, once Heads of Agreement have been signed, an MBO has less risk of failure than a sale to an external buyer; the management team is unlikely to come across any information it did not already know about that could put it off completing the deal.

Some family business owners are also attracted by the idea that they are giving an opportunity to continue the business to people already committed to it, and with whom the owner has built up a working relationship. On an emotional level they may feel they are passing the business on to known and trusted hands, rather than an unfamiliar third party. However, while an MBO has its attractions, several factors need to be considered:

- is the business suitable for a buy-out?
- does the buy-out team have the ability, financial resources and commitment?

- is the deal structure and price acceptable to both sides?
- can the deal be completed to an acceptable timetable?

A business suitable for an MBO must be commercially viable, run by an able management team and offering potential for growth, supported by an attainable business plan.

The management team must demonstrate its commitment and will need to persuade a venture capital firm to back the deal. To do this they must demonstrate that they have the skills to add value to the business and develop it further. They must also consider what exit

routes might be open to the backer, usually in three to five years' time.

In some cases vendors are prepared to give a small discount (no more than 5%) in the price they accept from a management team compared to the price required from an external buyer. This reflects the greater likelihood, in most cases, of the MBO deal completing. However, price negotiations should always take into consideration the number of such bidders and the strength of competition between them.

In terms of achieving an MBO, vendors and management teams generally underestimate the time it

will take to complete the deal. Legal completion may take up to six months. Vendors should also be aware of the danger that the management team may become distracted from the task of running the business. If performance slips, venture capital backers may try to reduce the price paid.

Owners should also be aware that some external companies will be put off from making a bid to buy the business if they know that the management team is itself trying to pull off an MBO. This is because they suspect the management team may have better knowledge to be able to complete the deal at an appropriate price.

MBIS AND BIMBOS

Sometimes the existing management team may not be interested in buying the business or may not have sufficient expertise. This could well be the case in a family business where the owner was closely involved in running the operation.

In such cases a management buy-in may be appropriate, with external management personnel joining the business and taking a stake in its equity at the same time. Venture capital firms often have such individuals on their books looking for suitable investment and management opportunities. Alternatively, the deal may involve a

Management buy-outs and buy-ins (continued)

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combination of an MBO and an MBI – where the existing management team buy into the business, but their skills are reinforced by a new joiner who buys in. A deal like this is called a BIMBO (buy-in management buy-out). It has several advantages in that it makes use of the existing management's knowledge of the business, while ensuring that they have all the skills and experience they need to realise their plans for growing the business in future.

BIMBOs may be somewhat more complex to put together than a simple MBO or MBI, but they can provide a useful solution where there are obvious gaps in existing management skills.

CASE STUDY: MANAGING AN MBO EFFECTIVELY

The owner of a family printing business wanted to retire and was keen to sell to his existing management team, since he had worked with many of them for several years. He was hoping to realise £10m from the sale. The business had been performing consistently for a number of years and the management team believed there were opportunities for its growth and development.

However, the owner's advisers suggested sounding out a few other potential buyers to stimulate competition. A number of potential

acquirers were contacted, and several of these expressed interest in the opportunity.

Meanwhile, the management team divided their time between running the business and developing their own business plan and acquisition proposal. Their venture capital backer suggested an offer price of £9.5m.

The owner hesitated, waiting to see if the third parties could do substantially better. Unfortunately, these companies discovered that the management team were also bidding and were reluctant to compete against them, believing their insider knowledge gave them too great an advantage. Despite waiting three

months, no offers were made by any of the external companies.

The management team's backer then reduced its offer to £9m, as turnover had stalled slightly during the intervening period while the owner was distracted by meetings with the potential external bidders. The owner decided to accept the offer, and the MBO completed four months later.

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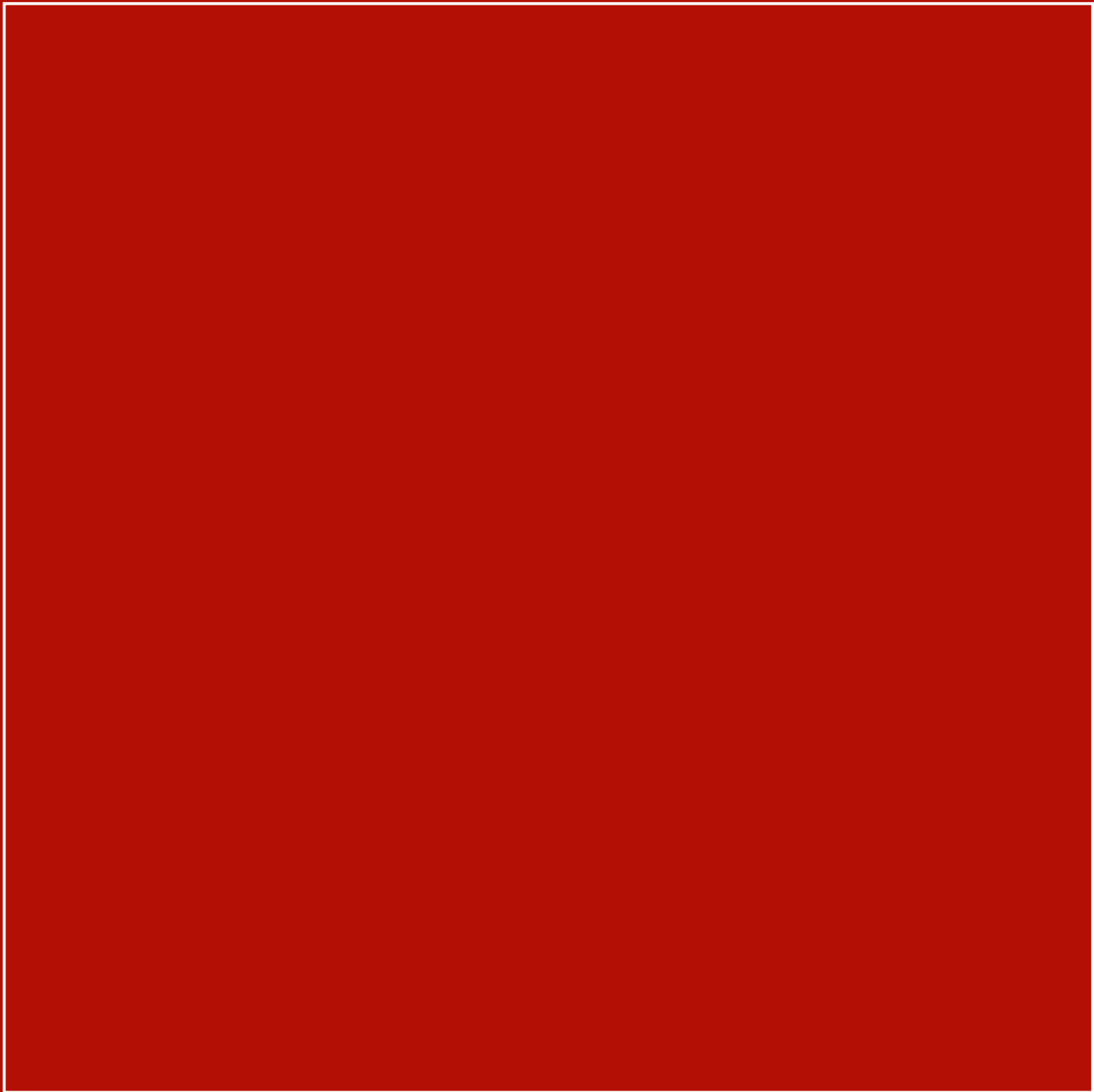
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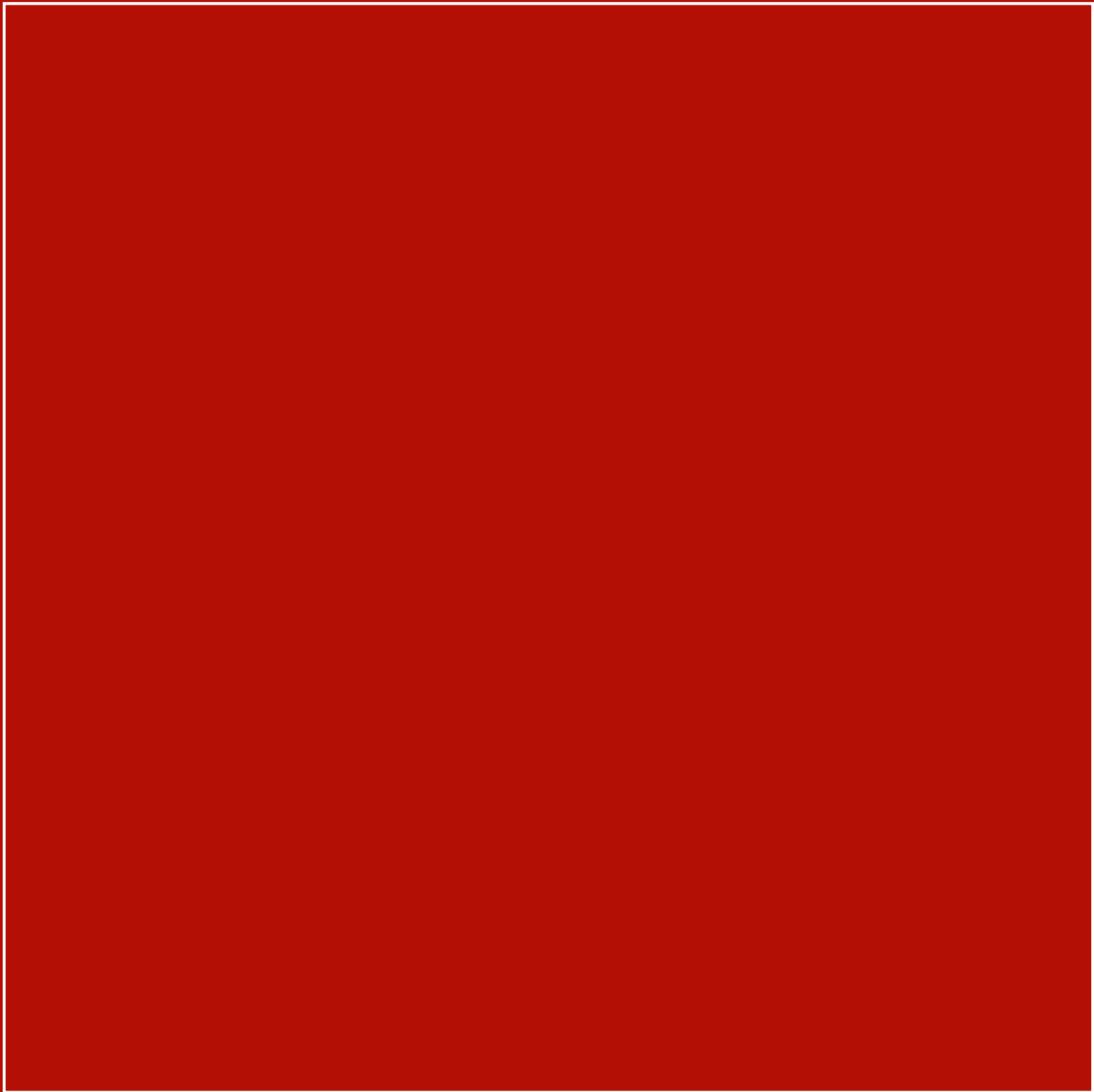
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Note: The Fédération des Experts Comptables Européens is due to publish in 2001 a guide for SMEs on carrying out business valuations.





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