CORPORATE
FINANCE

PKF FRANCISCLARK

Chartered accountants & business advisers

SELLING YOUR BUSINESS

A practical guide for entrepreneurs, directors, managers and shareholders

Supporting you and your business

Selling your business

A practical guide for entrepreneurs, directors, managers and shareholders

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1 Introduction

Selling their business can be one of the hardest decisions and processes for nearly all business owners. The majority of owners have little direct experience in this area but the successful outcome of the sale can be critical to securing the owners' future, either financially or in terms of passing the business to a succeeding generation.

> *"In this world nothing can be said to be certain, except death and taxes"*
> **Benjamin Franklin**
>
> *"and selling your business"*
> **PKF Francis Clark**

Looking back, most business owners (especially in the SME sector) view the sales process with little fondness, with the most common advice including:

- "Start early, many years before actual exit"
- "It will take longer than you expected and be far harder, financially and emotionally"

We have prepared this guide to assist you in this sales process, help reduce the stress and strain as far as we are able, whilst maximising the chances of a successful outcome. We cover herein:

- The rationale behind the decision to sell;
- A typical sales process;
- How to identify buyers;
- How much businesses are worth;
- How to ensure the sales process maximises the value of your business; and
- Taxation and legal issues.

PKF Francis Clark

History shows that experienced advisors are vital in the sales process, with their assistance ideally starting long before any sale is eventually achieved. PKF Francis Clark's Corporate Finance team is one of the most experienced transaction teams in the UK and we are always available for a no obligation initial talk to go through your options, including an assessment of the likelihood of an external sale and the potential valuations.

For further information, speak to our Corporate Finance partners Andrew Killick and Paul Crocker, or your usual PKF Francis Clark contact, or visit:
www.pkf-francisclark.co.uk/dealmakers

"I have had the pleasure of working with the PKF Francis Clark M&A team a number of times and specifically at times when we were undertaking an MBO and an AIM listing.

Quite simply they take the grief out of what can be stressful situations by providing a very real understanding of the challenge thereby delivering excellent advice and clear options while they manage the process competently and securely.

They are the best that I have worked with."

David Morgan,
Chairman of the Bray Leino group.

PKF Francis Clark advised David and his fellow shareholders on the £24m sale of Bray Leino to the Mission group, as well as numerous previous transactions.

2 Why sell?

The objective of a sale

Initial exit planning usually starts when the business commences, albeit usually unconsciously. Objectives can be modified over time, but often include:

- Selling the business for maximum value in order to retire or start a different business/project;
- Selling the business for "sufficient" value, whilst minimising on-going risk and/or role; or
- Passing the business to the next generation or its management team, either for value or as a gift.

Whilst maximising value of sale is not always a major concern (although often it is), the process of improving the value of the business usually also assists in achieving the other objectives above.

These objectives (or a mix thereof) can be achieved through a variety of exit avenues:

- Trade sale to competitor/diversifying group/individual/private equity firm
- Management Buy-Out ("MBO")
- Structured sale/gift to next generation (akin to an MBO in many ways)
- Joint Venture with long term acquirer
- Flotation (although this rarely achieves a majority of total exit option)

The above exits are all fundamentally different in many ways, and the earlier the potential exit route (or routes) can be identified, the sooner and more efficiently they can be achieved. This guide concentrates on external trade sales, and hence comes with a focus on maximising business value. We produce a separate guide on Management Buy-Outs.

When is a good time to sell?

Like many things, the timing of any sale is important, and control of this aspect critical. Whilst it is possible for a cold approach out of the blue to result in a successful sale, it is unlikely and will rarely maximise the chances of successfully achieving your original objectives.

The best time to sell is when:

- The business is no longer dependent upon its owners/founders for its day to day operations;
- Sales and profits have been increasing for some time and are expected to continue in this trend for at least the next couple of years;
- The business has sufficient capacity (in terms of space, machinery, staff, etc) to cope with sales increases for the foreseeable future; and
- The general economic cycle is relatively benign or in the early to middle stages of a boom (and we continue to hope for a return to these days!)

3 Grooming the business for sale

Early planning is key

We would always recommend assessing exit routes as early as possible and then updating this on an on-going basis.

The starting point for this process must be a realistic assessment of the long term objectives of each of the owners. Often these can be in conflict, especially if they have not been openly discussed before. Each owner must be open about the preferred timing of their exit and what they want to achieve by this exit, especially if this reveals differences that need to be resolved.

We often work with clients many years in advance of any sale, to maximise the chance of a successful exit. There are numerous actions that could assist matters that can only be implemented many years/months before any sales process is started.

Business valuation

The first stage of this grooming process often includes an assessment of the market value of the business, both now and at the time of the anticipated exit. We deal with business valuation methodology briefly in Section 6 of this guide. This assessment often highlights current matters that may be depressing the value of the business.

The future value can be based upon broad estimates of the financial, business and strategic position at that time, but importantly can both:

- Assess the realism of any exit consideration (often overstated in the minds of owners); and
- Provide a guide as to the actions required to maximise the value achieved.

The valuation exercise is also useful in identifying the potential acquirers for the business. Whilst a valuation takes into account the profitability of the business, different acquirers may attribute different values to a business. This is a key element of the exit process in identifying suitable acquirers and ensuring that the business is suitably set up and presented to them to maximise attractiveness. This can only usually be done as part of a tightly controlled exit exercise.

We have:

- Achieved significant premium value for an otherwise ordinary trading business to a supplier who was keen (or perhaps desperate) to ensure the business was not bought by a competitor
- Sold trading businesses to acquirers that merely wanted the business' land and were willing to pay a premium to a "normal" trading value to achieve this
- Seen loss making brands sold to a multi-brand (usually foreign) business for them to exploit across their other product ranges; and
- Sold moderately profitable businesses for a significant premium to larger buyers wanting access to a geographic region or a specific customer base.

Relevant factors such as the above should be encapsulated in any current or future valuation exercise and may help guide the future development of the business. We often provide detailed guidance from the above exercise that maximises the sales value.

Areas to address

The main areas to address during the grooming process are, obviously, those factors which tend to increase the value of the business or ease the transition process after any deal. It is important to consider this well before (at least two years) the potential sale to ensure the business can realise its maximum value.

It is also key to look at these areas from the buyer's perspective.

These factors are briefly considered below.

Creating formal management structures

A substantial proportion of the value of a typical SME can reside in the owner/management team. This tends to decrease the value of the company itself as the acquirer is unlikely to retain the exiting shareholders for any substantial period of time. Shareholder value is always maximised in a company where the shareholders are not critical to its management, and it has developed a strong second tier management team.

This is a key aspect of many of our grooming exercises. Although it does decrease profits in the short term, the reduction in time required by and reliance upon the shareholders;

- has a significant effect on the value of the business;
- expands the range of potential acquirers; and
- allows the owners more time to properly explore their exit options.

Diversifying customer and supplier bases

Over reliance on a single customer or supplier both increases the risk of a company itself (and hence depresses its value), and also exposes the company to the additional risks of those customer/suppliers. It is also difficult, particularly in the current economic climate to turn away business from your larger customers, but such concentration can prove fatal to exit plans, and such decisions must be taken in knowledge of this downside.

Improving management reporting systems

Having access to current financial results, future budgets and forecasts minimises the chances of any surprises during the sales process. It also ensures that the business can be presented (and valued in line) with the most recent results - important for any valuation based on profit in a growing business. The provision of accurate and timely accounting data will also help reduce costs and fees in the disposal process and provide greater assurance to the acquirer that adequate financial controls and systems are already in place.

You should also undertake a review of accounting policies to ensure they are in line with those in the industry or potential acquirer.

Such reports and systems facilitate the preparation of projections and provide better underlying evidence of their potential achievability. It cannot be understated the value that good quality financial projections can add to the sales process both in increasing the number of buyers and exit value achieved. They focus the buyer on the future potential of the business.

Finally, you should make sure your tax computations and liabilities are up to date. Documentation of all recent tax investigations gives assurance that the acquirer will not be inheriting any unforeseen liabilities.

Reducing/removing non business assets/liabilities and expenses

Minimising costs is an obvious tactic in the last few years before sale, but such reductions must not be at the danger of losing customers, suppliers or key staff.

The inclusion in the business of personal or non-business assets and costs will complicate the disposal process. Whilst it can be sensible for tax purposes to retain some surplus cash and properties in a trading company, this is often at the price of a more complex sale.

"I think you'll be pleased to see how low we've kept our costs."

Legal aspects

Matters such as:

- Ensuring contracts are in place with customers, suppliers and key employees;
- Litigation issues are resolved; and
- Registration of the business' intellectual property should all be dealt with well before any exit process.

Finally, tax planning should be addressed during this process to ensure that any tax on disposal is minimised. This is separately covered in Section 7.

4 The sales process

Introduction

In an ideal world, the sales process would begin several years before exit, as covered in our previous comments on grooming the business for sale. This places the business in an ideal situation to begin the formal sales process.

We summarise in detail in Appendix 1 a typical sales process with broad stages being:

1) Setting a sales strategy, covering;
   a) business assessment and valuation;
   b) agreeing overall strategy;
   c) identifying potential buyers and agreeing initial shortlist; and
   d) drafting marketing documents.
2) Marketing the business, covering;
   a) initial approach;
   b) tailoring marketing documents; and
   c) preliminary negotiations.
3) Indicative offers;
4) Offer evaluation; and
5) Final negotiations, due diligence and completion.

Key stages of the above are covered in more depth in the rest of this section, after a brief consideration on confidentiality and alternative marketing tactics.

Confidentiality

A key concern for many vendors is that the fact they are seeking to dispose of the business is kept confidential from employees, competitors, customers and suppliers.

Confidentiality is always a difficult area due to;

1) The potential legal requirement to consult employees before any sale, although this can often be mitigated in practice
2) The fact that competitors, suppliers and customers may be potentially attractive acquirers for the business; and
3) The sudden appearance of “men in suits” at the factory/office that always starts the internal rumour mill.

Whilst you should always obtain letters of confidentiality from all interested parties at the relevant stage, these are notoriously difficult to enforce in practice.

The critical issue is maintaining confidentiality at early stages to prevent any disruption to initial negotiations. Our marketing approach has been specifically designed to achieve this, by minimising the number of individuals “in the know” whilst maximising the exposure of the business to potential buyers.

As the sales process progresses, it is possible to minimise the chances of any confidentiality breach - our Corporate Finance team is always happy to dress down when visiting the site! However, the vendors must be prepared for rumours to start circulating at the later stages. This can be best handled by making sure the key internal management are brought into the process early, and suitably motivated to keep the business on track. Any acquirer will want access to key management, so this must be anticipated.

Alternative approach to business sales

It is obviously important in any external disposal to pursue discussions with more than one party. This creates competitive tension, increasing the likelihood of maximising the purchase consideration.

Whilst our approach will always achieve these within a selected group of potential buyers, there are two alternatives often quoted by general M&A brokers:

1) Taking the company to the already known (and limited) panel of potential buyers created by the commercial broker. Whilst this is often used in specific industries, such as care homes, this presents a specific conflict of interest to the broker, who will have to balance the needs of the vendor against those of the potential buyers, who the broker may want to preserve a good relationship with into the future;
2) A cold-call “all and sundry” approach. This immediately risks a breach of confidentiality, and also makes buyers less keen to waste their time participating in a large auction. It also rarely, if ever, generates any better leads than those identified in a much more selective strategy. On a recent sales mandate using our approach, we identified the ultimate buyer and three further competitive bidders after a fairly short marketing session with the client. A larger accountancy firm managed to identify only one potential bidder, whilst the broker was only able to promise that his approach always generated a large number of potential buyers, without any response to the issues regarding confidentiality.

The key factor that we find is not taken into account by the above cold call approach is that of maximising value by tailoring the information, presentation, documentation and valuation to the individual acquirer. Different buyers will have different requirements and different internal factors of their own. To ensure any sales consideration is maximised, the most important factor in any sale is to tailor the process to take account of these factors.

This can even take into account the different financial results that can be achieved by each buyer due to their potential synergies in terms of internal resources, locations, access to markets or sourcing. We can prepare a specific set of projections to account for the above, or the

cost savings/increased sales that the acquisition could have on the buyers' results themselves.

Our overall approach has worked extremely well over many years, as testified by numerous clients, some of which are quoted in this publication.

Planning stage

The first stage of any sales assignment is to undertake a thorough business assessment to understand the key business drivers. This will cover a valuation (see Section 6), assessment of management and an initial review of key tax issues.

This will also include a brief focused internal due diligence exercise to avoid any surprises later in the process.

> *"The team at PKF Francis Clark have been and are a great support to me in business. I feel that the firm really understands me and my business objectives, and it is very much part of the team".*
>
> **Deborah Meaden, entrepreneur and 'Dragons' Den' dragon.**
>
> *PKF Francis Clark advised Deborah on the sale of Weststar Holidays to Parkdean Holidays – a deal worth £83 million.*

Identifying potential buyers

Obviously a key matter at this initial stage is to identify companies that may be interested in acquiring the business.

Who?

Our work here starts with the business to be sold, identifying its competitive advantages (and hence why someone would want to acquire it) to start to define the characteristics of a buyer.

On the assumption that the objective is to maximise consideration, typically potential buyers could be:

- Already involved in a similar or related activity, including the business' own competitors, customers and suppliers;
- Engaged in a broadly similar business where there is compatibility or synergy between the businesses; or
- In a totally unrelated sector, where the buyer wishes to diversify.

In addition, there are still financial buyers, such as private equity houses and larger corporates seeking a better use of their cash resources, who may consider an acquisition as part of their strategy.

This gives a very broad range of potential acquirers, although in practice, many potential buyers are already known to you and ourselves through our contacts, or through awareness of the particular market. This is particularly true of niche sectors. We have never failed to come up with potential buyers for even the most unique of businesses.

How?

Corporate Databases – Based on the above we can use our comprehensive UK, European and Global corporate databases to identify potential acquirers from either their past acquisitions or size and sector. Searches on these databases can, naturally be tailored as required.

We also track buyers in particular sectors such as food and drink, renewable, manufacturing and engineering, healthcare, recycling etc.

Sector groups – Certain industries such as printing and food and drink have specific sector groups that are often useful in identifying potential buyers.

M & A Database

PKF Francis Clark maintains a database of professionals and companies engaged in the regular purchase or sale of businesses.

PKF Francis Clark can also provide potential buyers plus feedback on the information memorandum.

PKF Francis Clark LLP is a member firm of the PKF International Limited network of legally independent firms. PKF International , along with other M&A contacts, provides us with excellent coverage of potential buyers in the UK, Europe, USA and beyond and we have undertaken numerous deals throughout Europe and beyond through this network.

Past Clients – we have acted for numerous buyers and been in contact with others from the other side of the fence. We can therefore provide suggestions from our previous experience, although we would always be clear that you are our client and any past associations would not affect our work for you.

Summary

We would tend to combine the above potentials with your thoughts on who might be interested to produce a first draft long list of potentials. This list is then refined into a short list with priorities.

An obvious tip is to never ignore any avenue when looking for potential buyers, especially if the buyer suggested was not your idea in the first place.

Information Memorandum/and Teaser/One Pager

The Information Memorandum (“Info Memo” or “IM”) is the key document that introduces the business to potential buyers. The actual size of the IM will depend upon the nature and complexity of the business being sold, but typically it will include:

- Introduction to the business and reason for disposal;
- Brief history and description of the business;

• Current operations undertaken;
• Overview of customers, suppliers and contracts often on a no-name basis;
• Directors/owners and senior management;
• Details of the property occupied; and
• Brief financial information, both historic and projected.

The skill is in providing sufficient information to excite the interest of prospective buyers whilst limiting sensitive information whose disclosure may damage the business. Whilst it is not issued without obtaining a confidentiality letter, it must always be borne in mind that the potential acquirers may not buy the business and the information will therefore remain in their hands for the foreseeable future.

The preparation of the IM takes place at the same time as the identification of potential buyers so that the document can be tailored to be specific to those buyers, and it is possible to produce several different versions of the document which emphasises different aspects of the business. It is important for you to look at the business as if through the eyes of the buyer and identify what its most attractive features are. *The importance of this cannot be overstated.*

For instance, the ability to relocate the business may be of more interest to a distant buyer, whilst another buyer may be more interested in the ability to transfer the brand concept across their diversified product base.

For legal purposes, the IM must be factual and objective but its legal status should be clearly defined e.g. that it is not to form part of any contract for the acquisition of the business.

We refer above to the inclusion of projected financial information and this can be key to increasing sales value, as referred in other places in this guide. Such projections must however be realistic, although the buyer is expecting an element of optimism in their preparation (you do not guarantee the delivery of these figures in the end sales contract). We always recommend that these projections are prepared in an integrated fashion (profit and loss, cashflow and balance sheet) both to aid in the assessment of their realism and also show the working capital requirements of any growth have been assessed.

Finally, if the projections show a significant increase in turnover or profit over the projected period, you must be very clear as to the catalyst of this change – why is this going to happen and how certain is this?

We often use a one page anonymous “teaser” letter or email to act as a precursor to the IM. This is circularised to the agreed short list of potential buyers to see if they are interested. This shorter document is anonymous and is made as confidential as possible to prevent identification of the company. It is therefore possible to minimise the information made public to those who are not interested in pursuing an acquisition.

It is fair to say that a well prepared and presented IM has a much higher chance of achieving a sale than a quickly drafted document. Time spent on preparing/tailoring the memorandum is always rewarded.

Vendor due diligence

Formal Vendor Due Diligence has long been part of larger transactions and is becoming increasingly popular. It involves you commissioning your own due diligence report on your business that can then be provided to acquirers to give them an independent view of the business, its history and its prospects. The due diligence usually consists of an accountant's report covering areas such as a review of the historic trading record, the net asset and tax position, and an analysis of the assumptions underlying management projections.

The advantage of undertaking this process is that you can control the timing, undertaking it earlier in the process and thereby considerably shortening the time between final offers and completion. The report is formally updated and assigned to the buyer during the final stages of the deal, and will significantly reduce the investigative work to be undertaken by the buyer.

We would always do an element of due diligence during the preparation of the IM, and we often recommend that a lawyer does a mini legal due diligence exercise early in the sales process to identify any issues early.

Indicative offers

The IM should result in either the receipt of initial offers (often in range of values or dependent upon certain assumptions) or a request for more limited information. This limited further information can often be provided in the form of a (virtual) data room, where all potential acquirers have access to the same information, often electronically.

Refining these initial offers into final offers, and selecting the party with whom to proceed towards completion, takes us into the negotiation phase.

"Could you be a little bit more specific than an 'arm and a leg'?"

Deal negotiation

Many vendors find the negotiation stage the most frustrating part of the whole process. As mentioned above, you must have a good idea of what you are prepared to accept for your business before the negotiations commence, otherwise it is unlikely that you will maximise the proceeds.

We can help make sense of what is a very stressful period for you. It is possible that a buyer has acquired businesses before; it is unlikely that a vendor has sold a business before.

The first task for the negotiations is to agree the basic terms of the deal, often in the form of Heads of Agreement. This is a fairly short agreement setting out the main terms of the agreed deal such as price and exclusivity period, and is covered in more detail in Section 8. Getting to this stage can involve face to face meetings to clarify certain matters but also to allow the vendor to make their assessment of the potential buyers.

Signing the Heads usually commits both parties to a period of exclusivity, allowing the buyer to carry out their own due diligence enquiries as needed and negotiate the final contract without the concern that they might be dumped at the last moment.

Purchaser due diligence

The extent of this exercise depends upon the level of vendor due diligence carried out beforehand. The aim of this exercise is for the buyer to gain comfort that there is nothing relevant about the business that he has not been told and that all the information provided is accurate. It covers legal, financial and commercial matters.

It is especially relevant to share/company purchases, where the acquirer picks up all the assets and liabilities of the company, whether they have been told about them or not. In an assets acquisition, the exact assets/liabilities being acquired are defined precisely in the legal agreement, with the sole exception of employee commitments that are automatically transferred under TUPE regulations.

Completing the deal

The actual sale will be dealt with by a legally binding contract (which will include the warranties and indemnities, referred to in Section 8) and this is where the solicitors and accountants spend a great deal of time.

There is always an element of compromise required, and what appear to be major stumbling points can rapidly become of less importance as the target completion date approaches. Conversely, matters that may appear of little significance can suddenly become very important, right at the last minute.

The completion meeting will always involve both yours and the buyer's respective solicitors, and quite often your respective accountants and other advisors. The usual format is that everyone agrees a time and date, and then you lock yourselves in a room to ensure that all the necessary documents are signed, meetings held etc.

This is a meeting at which last minute decisions and compromises are made and it is vital to agree your strategy before you go into the meeting. There will often be one or two absolutely key points which still have to be resolved, and the way that negotiations usually take shape is that there has to be compromise on both sides. You will always be aware of the areas of lesser importance where it may be advised to give way gracefully so as to achieve the important points that you are really looking to satisfy.

Only once all of the necessary meetings are held and documents signed will the deal have completed, the necessary funds have been transferred and the champagne opened.

Completing a successful sale is a long and complicated process. A typical deal from conception to completion can take, on average, six months and sometimes longer to complete.

Even then, most deals include a consultancy period, which can be between one month and three years, in which you assist the acquirer to achieve a smooth handover period.

5 Deal structuring issues

Shares v assets

In any sale of a company, a key question to be resolved early will be "what exactly is being offered for sale?" Typically, a buyer would prefer to acquire the business itself and relevant underlying assets, rather than the company (via its shares), since this avoids the inherent risks of liabilities, which may "emerge" in the company. However, a seller will want to dispose of the shares in the company so as to avoid a double tax charge:

- firstly corporation tax on any "profit" element of selling the business and assets by the company itself; and
- tax on the individuals on their payment from the company.

Selling the shares avoids tax being paid in the company, and simplifies the transmission of the money to the shareholders direct rather than through the company.

In reality, the majority of company sales are via shares, but this does complicate the sales process as the buyer will need comfort (from due diligence and an expanded sales contract) that he is not picking up any unknown liabilities or "skeletons in the closet".

Separate trades

There are situations where a business may consist of two separate trades or assets of which only one is to be sold. More often, the company can contain both a trade and a property, and the vendors would like to retain the property. Without some fore thought, this could be structured with the property being taken out of the company by dividend (at least 25% tax plus capital gain in the company) or sold to the vendors by the company (requirement for cash by vendors and still capital gain in the company).

There are tax efficient ways of splitting trades or trade from property that avoids the above, although it can involve a fairly complex tax restructuring. Further advice can be obtained from your usual PKF Francis Clark contact.

Deferred consideration

An increasing trend over recent years is for a majority of deals to include an element of consideration that is not payable at completion, either in the form of:

- Deferral - simple unconditional deferred consideration, being amounts due at some stage after completion, such as £1m payable 12 months after completion; or
- Earn Outs – where not only is part of the consideration deferred, but the amount is dependent upon future events, such as the performance of the business after completion.

These can often happen where the profit record is uneven or the price is higher than commercial.

There are considerable tax implications surrounding deferred consideration that our tax department will need to discuss with you to avoid either being taxed upfront on the deferral or having complex valuation issues raised by HM Revenue and Customs.

An earn-out agreement involves the acquirer paying an initial consideration and agreeing to pay more, if certain criteria are achieved, for a specified number of years after the acquisition. These contingent payments are usually calculated on a multiple of future profits with a maximum sum being set. The future payment can be by shares in the acquirer, cash or by a mixture of both.

Acting for a vendor, we would tend to strongly resist any deferral or earn out element, but sometimes they are unavoidable especially in the current economic climate. There are, however, steps that can be used to minimise the risk involved:

- Insist any deferral backed by a bank guarantee to ensure its payments regardless of the success (or otherwise) of the buyer;
- Minimise any period of deferral or earn out; and
- Link any earn out calculation to measures that are less easy to distort, such as sales (perhaps unit rather than £) or gross profit rather than net profits.

6 Valuation of your business

Introduction

Valuing a business is a very imprecise science (in that there are rules but they are usually vague and rely upon many subjective judgements). However, in any sales process, an estimate of value is the starting point, and we often advise clients to undertake a current valuation, as well as an estimated future value to guide the sales grooming process.

Basic valuation techniques

In the majority of cases, the acquirer is buying your business for the future profits they will earn from it, and the majority of valuation techniques are on this basis.

The purest form of valuation therefore involves predicting the surplus cash that will be produced by the target over the next few years, building this into a suitable model and discounting this back to arrive at a present value for the company.

However, there is a great deal of debate about the suitable discount rate to account for the risk of the business (as well as the time value of money). As such a number of other methods have been developed to simplify the process, often by using comparative factors to other deals that have completed.

These include:

- Multiplying the underlying profits by a factor, known as the Price Earnings Ratio (PER) obtained from discounting plc's ratios or from databases such as PERDa (a database PKF Francis Clark maintains);
- Specific sector related valuation which may relate to turnover or net assets; or
- Re-valuing all assets to present values (mainly used for property companies).

We use a combination of the above methods in our overall assessment of valuation.

Profit multiple

Underlying profit - The underlying profit used in this method is usually derived by taking the most recent profits and adjusting them for such items that were either one-off or will not continue after the sale. Such items usually include:

- Payments, such as salary, pension and company cars, made to individuals who will not be required after the sale, for example, payments made to retiring director/shareholder spouses;
- Remuneration and other benefits for retiring shareholders acting as consultants;
- Excess remuneration for individuals where their replacement will be on a reduced salary;
- One-off substantial gains and losses made on the sale of company assets;
- Interest paid on directors' loans;
- Excessive (or no) rent paid on buildings owned by the vendors or being retained during the sale by the current shareholders;

- Adjustments for profits/losses made on sales to other group companies; and
- The alteration of the tax charge to a notional charge at normal corporation tax rates.

The above should be applied both to historic and future projected profit. We would want any acquirer focussed on the future potential and spend significant in any sales process on the preparation of realistic projections, supporting either a higher overall valuation of justifying a lower PER multiple to the acquirer.

In addition it is important to include in the assessment of any underlying profit, any synergies that could be brought to the business by the acquirer. Although the actual inclusion of these items is always resisted by the acquirer, these can often prove useful in the final negotiations as to the attractiveness of the acquisition – again focusing on the other side of the deal and properly understanding their position.

Relevant multiple - Once the underlying maintainable profit is estimated this must then be combined with a profit multiple, the derivation of which is far more subjective than assessing the maintainable profit.

Firstly we would look at details of specific recent deals in your business sector from a variety of proprietary databases to assess a comparable profit multiple. We track specific sectors such as food or retail on a regular basis so we will be able to advise on a relevant ratio.

We then use our own unique database (known as PERDa – www.perda.co.uk) of comparable deals involving private companies in the UK and Europe. In addition, we use our own unique database (known as PERDa) of comparable deals involving private companies in the UK and Europe. This has been compiled on a confidential basis using a number of firms. It has been recognised by HMRC as an acceptable benchmark for valuations.

The Buyer's perspective

We often emphasise in this publication it is important to gain an understanding of the buyer's viewpoint on your business and this includes, obviously, the valuation. We quite often see simple methodologies used by buyers such as Internal Rate of Return and it can be useful early in the process to understand this methodology, in order to tailor the information provided, even down to including your workings on their calculations.

Negotiations

We regularly discuss with vendors whether they should state the price they are expecting for their business up front. Unfortunately there is no one correct answer to this, although most M&A broker houses we see always advise to wait for offers to set the price. Whilst we will always provide our opinion on valuation, including this in the IM or teaser does depend upon the circumstances. It can set a useful starting point for negotiations, whilst also immediately cutting out the potential for realising much more than this amount from the process.

It might also dissuade bids, where the buyer could actually (without the target price being disclosed) be persuaded towards the target if suitable, tailored information is provided to emphasise the potential attractiveness of the target.

7 Taxation issues

Capital gains tax

The most important area for taxation planning concerns Capital Gains Tax (CGT). CGT rates are effectively at 28% for individuals except where Entrepreneurs' Relief ("ER") applies.

ER provides a lifetime individual £10m allowance of gains made from the sales of qualifying business assets (including shares in a trading company) to be taxed at 10%. The individual needs to have held >5% of the voting shares in the company and be an officer or employee, both for at least 12 months before any sale (although see EMI section below).

Diversion of consideration to management

A key requirement for many vendors can be rewarding the non-shareholding management – this can be a critical element in the sales process and thereafter in ensuring the business continues to run normally. However, any straight forward gift or diversion of the consideration can result in:

- The shareholders being taxed on the full amount of the consideration (including the part they have surrendered to management); and
- Management being taxed at income tax rates (up to circa 50%) on their diverted consideration.

Obviously the above is the worst of both worlds. It can be tackled however, if looked at before the sale. In addition, by the use of certain tax efficient share options schemes such as Enterprise Management Incentive ("EMI"), it is possible to both address the above and create a tax deduction in the company being sold that we often manage to include in the consideration so actually increasing the overall consideration.

Other tax issues

It is possible for older shareholders that the conversion of shares to cash may prove disadvantageous for Inheritance Tax ("IHT") purposes. Whilst shares in a trading company may be exempt from IHT, cash is not. It may therefore prove beneficial for older shareholders to transfer shares to their children/grandchildren before any sale.

We have already touched briefly on the difference between the sale of assets and shares in a previous section. There are also differences in the treatment of stamp duty and VAT when assets or shares are sold but these generally impact on the buyer.

We advise that you ensure that all corporation tax, VAT and PAYE compliance is up to date. All outstanding matters should be settled to ensure that no issues exist which could be blown out of proportion by the acquirer in any negotiations.

Stamp duty, while payable by the acquirer, is part of most transactions and, particularly in respect of property transactions, the acquirer may utilise schemes to mitigate their liability.

8 Legal issues

Heads of agreement

A key part of the process, and discussed earlier in Section 4. Areas typically covered are:

- Outline of transaction and structure;
- Consideration and terms of payment (cash on completion, deferral, earn out, etc);
- Basis of valuation;
- Anticipated completion date;
- Access to information and senior staff;
- Any specific conditions e.g. confidentiality, exclusivity, change of name;
- Warranties and indemnities expected; and
- Each side to bear their own costs.

Apart from exclusivity, heads are usually not legally binding: they are rather a statement of interest in doing a deal; However, the tone and some of the details make renegotiation more difficult (although not impossible). We put significant effort into ensuring the heads cover all the major points to minimise disputes during later negotiations.

Share Purchase Agreement (“SPA”)

If you think negotiating to Heads of Agreement is difficult, then this is where the fun really starts!

The SPA is usually a lengthy document and will include sections dealing with warranties and indemnities (see next section for more details of these terms) to be given by the selling party. These are areas that are always negotiated between both parties; the buyer would like to have the comfort of knowing that if things are not as expected, comprehensive warranties/indemnities and a reasonable retention will be held whereby deductions can be made against the retention, thus reducing the actual price paid. You will want the reverse position e.g. no/minimal retentions and minimal warranties/indemnities given.

It is inevitable that as part of the due diligence, the SPA will continue to be shaped and in our experience the final SPA often bears only a passing resemblance to the original Heads of Agreement. This is not necessarily a bad thing and should reflect a far more thorough understanding of your business than could possibly have been achieved simply by initial discussion.

Warranties and Indemnities - Warranties and Indemnities are usually among the most important provisions of SPAs, especially in this increasingly litigious society.

Warranties are terms included in the sale agreement whereby the vendors confirm, for example, ownership of assets, that certain liabilities have been fully disclosed (such as previous years’ corporation tax bills) and that certain events have not occurred, for example, the business being sued. If the warranties do not prove to be correct, any loss may be recoverable from the vendors.

Warranties are used as part of the legal discovery process. A full set of pro forma warranties is initially provided, and these can stay in this form in the final agreement. However, the vendor can make disclosure against these warranties, which would negate the ability of the buyer to sue him on that point. It is important to understand however, that the original warranty may remain in the SPA.

For instance, a warranty may state that the business is not being sued by anyone. The vendor discloses that there is a pending court case involving an individual who tripped in their car park and is trying to recover personal injury damages. Having made a reasonable disclosure against this fact, the vendor cannot be sued under the SPA in respect of this fact, even though the original warranty is likely to remain in the agreement to cover the buyer in the event of other such litigation.

Damages reclaimable under warranties require the buyer to prove that the warranty was breached and that this breach resulted in them paying too much for the business (this is slightly simplistic but communicates the underlying gist of the intention). It is this overpayment of consideration that then becomes the amount payable under the warranty claim.

Indemnities are terms included in the sales agreement whereby the vendors state they will cover stated events or liabilities such as outstanding legal cases. They are different from warranties as the vendor has to pay £ for £ for any indemnity claim (as opposed to above more complex warranty damages quantification).

To continue the above car park example, it is likely that the buyer would insert a specific indemnity regarding this claim, so any payment made to the individual would be reclaimable from the vendor (or more likely deducted from a retention account).

It is vital that all warranties and indemnities are carefully considered, particularly those relating to taxation issues.

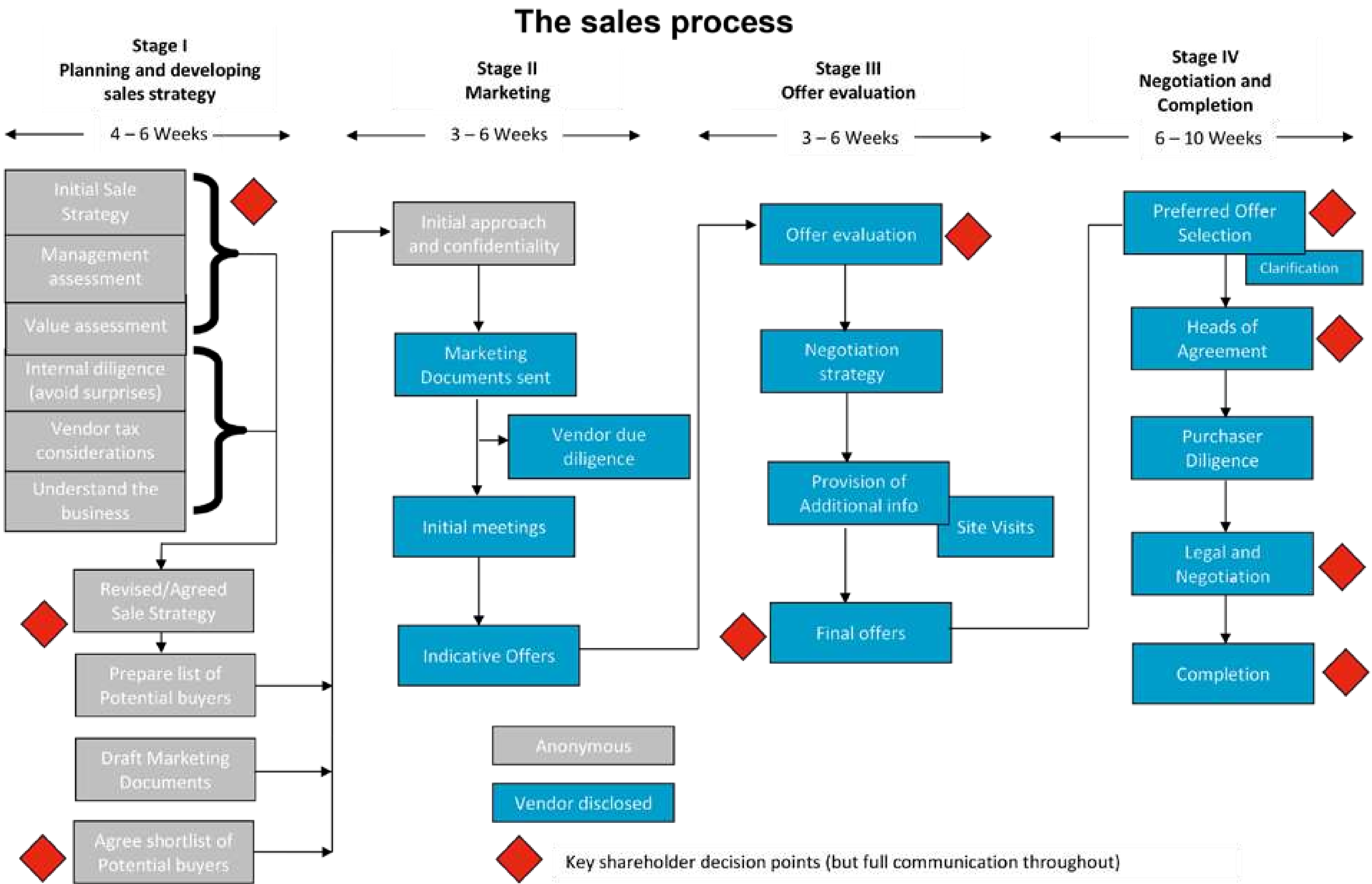
It is also possible for you to limit the risk that you are subject to post-completion by receiving good legal advice and restricting the purchaser’s rights. The usual example of this is to set a cap on the total amount of claims, usually at the consideration paid, but you also include a de minimis of the claim that they can pursue (either individually or in total).

9 Conclusions

The previous sections give an overview of the sales process and key factors in making it successful. The key lessons we have learnt over the years can be summarised as follows:

- Properly set out the objectives of all the owners well before starting any exit process;
- Start planning for the exit as early as possible, and allow at least six months for the process itself;
- Be realistic in your assessment of the valuation of the business;
- Look at the deal at all times from the perspective of the buyer (or potential buyer);
- Ensure you tailor all information provided during the process to include factors that may make the business more valuable to certain buyers;
- Always consider potential acquirers from non-related sectors;
- Keep your key staff, suppliers and customers in the loop as needed;
- Appoint experienced advisers to make the process as smooth as possible and maximise the value, but be prepared for it not to be a pleasant experience. In particular, do not get so involved in the process so as to forget your original objectives. Sometimes you need to walk away from a bad deal rather than regretting a completion for many years thereafter; and
- Try and keep a sense of humour during the process, and keep a sense of perspective about the negotiations.

Selling your business - Appendix 1: A typical sales process



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