The Hornbeam Guide
to
Successfully Buying a Business

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Chapter 1

Introduction

When Bill Gates began negotiations with IBM to provide operating software for their new breed of personal computer, he neither had such a program nor time to write one. Instead he quietly acquired the business that wrote the MSDOS software that was the foundation of the success of the Microsoft Corporation!

Almost all of the world's most successful businesses have used acquisition at some stage in their development.

Jack Welch's autobiography 'Jack' contains some excellent chapters about the acquisitions that helped make GEC one of America's most successful companies and Jack Welsh its most admired business leader.

However, small and medium sized businesses are often reluctant to expand by acquisition and many opportunities are lost, both for the business owners and for the economy as a whole. The purpose of this book is to provide the managers of small and medium sized businesses with the tools and the confidence to expand their own businesses by acquisition.

The fear of getting it wrong is perhaps well founded, and I tackle this head on by devoting an entire chapter to learning from other people's mistakes (chapter 4). However, fundamental to my proposition is the belief that many business people underestimate the costs and risks of going for organic growth. I have therefore also devoted an entire chapter to discussing the pitfalls of going for organic growth (Chapter 2).

The overall layout of this book is to take you through the acquisition process

I dedicate this book to those many clients with whom I have worked to make their businesses a success. I hope those clients who think they recognise themselves will do so with enjoyment or at least with wry humour.

I am sure that many of my clients would want to join me in hoping that we will help readers to profit from the experience that we acquired over many years, much of it the hard way!

The Big Picture

There are some very good theoretical reasons why an economy needs small business to go for growth by acquisition

1. It provides a route for other small businessmen to profitably exit the businesses that they have created, and thus adds considerably to the rewards and incentives available to small-scale entrepreneurs

2. Many small entrepreneurs are reluctant to sell up to big businesses which may have an alien culture, and which will probably not have the same commitment to employees and customers

3. Large firms have a huge investment in their existing products and technology. They are reluctant to invest in a new technology that offers better quality, cheaper prices, or improved functionality to customers, **if** it will cannibalise existing profitable product lines.

For example (1), none of the established domestic cleaner manufacturers would back James Dyson's new cyclone technology, forcing him to go it alone.

For example (2), large software companies systematically buy up and close down (they call it integration or rationalisation) innovative smaller competitors.

For example (3), the UK motor insurance industry was shaken up (and significant costs taken out to the benefit of the customers) not by an existing insurer, of which there were many, but by a start-up business (Direct Line), which was taken over and grown by another firm from outside of the industry, a bank actually!

So economic progress is disproportionately dependent upon smaller companies with no investment in outdated technology. The more rapidly small innovative companies can grow, the more rapidly economic progress can be disseminated throughout the economy.

Many economists think that the recent astonishing growth in the American economy from its already high base can be traced back to the growth of innovative new businesses. Many of America's largest businesses did not exist 20 years ago. In contrast, growth has been derisory in Europe and Japan where barriers to growth for new companies are so much greater. There are very few businesses comparable with Microsoft, Intel, or Cisco in Europe or Japan.

Chapter 2

Why Expand?

There are many reasons for wanting to expand a business, some more valid than others. I challenge the reader to make their own list before reading mine.

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Here is my list of reasons for wanting to expand a business

- To diversify a ‘too small’ pool of customers
- To earn more
- To justify continuing employment of key staff (or family members!)
- To attain a critical mass which will enable costs to be driven down, including by better buying power
- To build up a business to a size at which it can be sold for real money
- To bring a new technology, product, or service to a wider customer base
- To acquire better technology, systems, people, or facilities
- To make better use of existing fixed cost facilities
- To get out of declining markets and into growing markets
- Because managing a growing, innovative successful business is more fun and more satisfying than managing a static or declining business.

I believe that the following sentence encapsulates pretty well all of the valid reasons for going for growth.

‘To leave the business owners wealthier than if they did not go for growth.’

Incidentally, I would just like to say that I have a lot of time for people who choose to stay with a small business which produces an adequate income without too much effort or stress. Good luck to them I say.

Lastly, here are a few ‘reasons for expansion’ to be avoided

- To increase sales. (Remember the old adage – ***Turnover is vanity, profit is sanity***)
- Because I can manage the business better than the existing owners. (Maybe you can, but many businessmen underestimate the contribution made by the vendors of the businesses that they acquire. Many successful businesses fail to match the turnover achieved by the previous owners after they are taken over. Many small businesses, that have thrived on the hard work and personal service of their proprietors, disintegrate when they are acquired by larger businesses).

Chapter 3

Why Acquisition?

It is important at this early stage of the book to debunk the myth that organic growth is in some way 'better' than growth by acquisition.

Firstly, organic growth is anything but cheap. Here are some of the costs associated with organic growth:

- **Investment**. Setting in place new capacity means laying out money before sales can begin, often plant must work at *low utilisation* for a long time whilst demand builds up, often there is much waste and many setbacks whilst *glitches in new technology* are ironed out

- **Winning new customers**. Big businesses spend heavily on *advertising* and *marketing* and maintaining *sales teams* just to maintain their market share. For a small business there is often simply not enough profit to fund an advertising campaign, or even a single marketing or sales executive, without tipping the company into loss. Bank managers, who may be persuaded to fund a new factory, will rarely agree to fund a sales and marketing campaign

- **Pricing**. Acquiring new business by *competing on price* will tie the business in to a cycle of low prices and low profitability

- **Problem customers**. Once you have won them new customers almost always include a disproportionate number of *problem customers* who will end up as legal disputes or *bad debts* rather than profits

- **Working Capital**. Capital must be found to finance the expansion of stock, work-in-progress, and debtors. Often the only route open to finance increasing working capital needs is *factoring* – which is the most expensive and inefficient form of finance available

- **Spiral of decline**. All of the above result in the business showing *low profitability or losses*, this in turn has many disadvantages, and results in many more costs for the business. Suppliers will restrict credit, bankers will restrict access to funds, the cost of borrowing will rise, and recruitment, remuneration and retention of key employees will be more difficult.

It is pretty easy to see from the above that not only is organic growth likely to be expensive, but it also involves some very big risks too. It is relatively easy to put the infrastructure in place ready to expand a business but building up sales is almost always a slow process, and, in these circumstances, costs can easily outrun income and cause the business to spiral into failure.

Here are a few of examples that I have observed from amongst my client base

1. Start-Ups

Nearly every start-up-business tries to cut out a niche for itself by competing on both price and superior customer service. The second of these is sustainable, but typically the market price for a product of service is that at which the providers can earn a reasonable, but not exceptional, living. By competing on price, the proprietor of the start-up business condemns himself to years of long hours and a poor standard of living.

2. Expansion and Diversification

Having one (or a few) large and profitable customer(s) is better than not having any, but whilst these customers must be looked after to the best of one's ability, to build up a stable business one needs a diverse and stable range of customers. In fact, dependence on a handful of important customers can create a strong feeling of paranoia. It can also result in unreasonable pressures to reduce prices and of course there is enormous risk of business failure if the customer is lost. Several times I have seen clients in this situation do what appears most sensible. They develop a strategy for expansion and diversification. Usually this involves moving to larger premises, acquiring more plant, and taking on sales staff. In most cases this has resulted in a drastic ***reduction in profitability***. Most reassess the situation after a couple of years and, in truth, very little expansion has been acquired at very high cost. All the businesses had been caught out by ***problem customers***, who had seemed to promise much, but had ended up as bad debts. In all the businesses the sales effort had tied up much senior management time. In all the businesses ***direct sales costs*** (sales department salaries) alone exceeded any additional income generated over the period.

3. Successful Sales Growth

Perhaps the most frustrating cases are those businesses that succeed in growing the top line but get in a terrible mess anyway. It is an easy misconception to believe that sales growth always results in increased profits. In fact, very few overhead costs are 'fixed', many grow faster than sales. For example, an owner manager may find that he needs to take on an assistant manager, or a customer account manager, or whatever, whose salary takes a big chunk out of profits. A rapidly growing company usually needs to take on new staff, who need to be trained and need time to learn the company 'way of doing things.' Even when trained they often lack the commitment and productivity of longstanding employees. Managing growth can be extraordinarily difficult, as new ***technology glitches***, production runs become disjointed, new employees are not properly integrated, and facilities become overcrowded. And if all these problems are overcome growth is rarely cash generative.

Growing companies often find that increasing levels of stock, work-in-progress, and debtors tie up more cash than is being generated from growing profits. So growing businesses are often strangled for ***lack of cash*** or forced into very expensive deals with factoring companies or business angels. All of these problems are generic, and I have seen them many times.

Two examples from the world of big business show just how widespread these problems are

1. Lack of Cash

Even if you are building up one of the most successful businesses in the world, the cash demands of organic growth will undermine the trust of bankers and investors. Two decades ago the management of a British electronics business called Racal were investing massively in new mobile telephone technology. Profitability suffered and cash calls on bankers and shareholders caused the company's share price to collapse. Eventually the mobile telephone subsidiary Racal Vodafone had to be demerged and floated separately on the stock market. Fortunately, enough cash for investment was raised and subsidiary went on to become one of the largest businesses in the country.

2. Expansion Overload

A few years ago, Boeing had to stop its entire production process because rapid expansion had brought its manufacturing plants to a state of chaos. Only by stopping the whole thing and installing new systems did management regain control of the plants. The cost of this to Boeing in terms of money and humiliation hardly bears consideration.

On the other hand, a good acquisition will bring at least some of the following

- An established customer base
- The ability to make a profit and generate positive cash-flow from day one
- Operational and computer systems that are already up and running, perhaps they are better than those of the acquirer!
- Trained and experienced staff, perhaps new skills that the acquirer is seeking.

This calculation probably underpins a great number of the small business purchases that take place. Put simply **it is often cheaper and less risky to buy an established business than to set up a new business from scratch**.

However, acquisitions can bring much more than this

- The possibility of synergies, cutting costs by reducing premises, adopting superior systems, better buying, reducing the workforce

- The ability to offer a wider range of product or services.

Chapter 4

Avoiding the Pitfalls

The business pages of any good newspaper are full of stories of huge businesses that have failed in spite of (or because of) massive acquisition policies. In fact the multinational accountancy firm KPMG carry out periodic surveys of the success of major takeovers, and in 2003 were delighted to declare that the percentage of major takeovers which could be adjudged a success from the point of view of the shareholders of the company doing the acquiring had improved to 34%!………. So presumably 2/3 of all major takeovers failed to benefit the shareholders of the acquiring company!

Before we consider how to make an acquisition work, we should consider why so many big acquisitions fail. The authors of the KPMG report felt that the improvement in success could be tied back to better research. Whilst I would agree that research is important this seems to miss the three big issues that undermine so many big company acquisitions

- Executive remuneration is highly correlated to the underlying size of the company, so executives often have an incentive to grow the company at any cost

- The team of advisors often manage to negotiate a 'success fee' for completing the deal. In these circumstances few such teams will ever advise a client to walk away from a deal!

- When the deal is done the takeover team is paid off and split up. But this is just the moment when people with high ability and detailed knowledge of the target business are most needed, to make the acquisition work.

Without claiming any exceptional talent, most of the takeovers that I have been involved with have been either successful or very successful. This is surely because my clients own their businesses as well as managing them

- So, they are strongly focused on profitability, and unlikely to be seduced by issues of vanity

- I have never asked for or been offered a 'success' fee when working on an acquisition

- and because once the takeover is complete these guys work incredibly hard to make a success of integrating and managing the acquired business.

My type of client would find strategic objectives such as 'being no.1 or no. 2 in every market in which we operate' a poor joke.

The things to take from this chapter are that the real reasons for failure are

1. Paying too much, and

2. Underestimating the work (and resources) needed to make a success of the acquisition after the deal is struck.

These are not complex or technical issues. If you establish the value of the target to you at an early stage and aren't be suckered into overpaying, then you have won half the battle. If you understand that managing, integrating and developing the new acquisition is the really important part of the process then you are well on the way to success. I will discuss many other pitfalls throughout the book, but these are the main two and you should remember them at all times.

Case Study

Mayflower is a UK listed company which failed recently. If the press are to be believed then the roots of that failure are not to be found in the fact that it is in a declining UK engineering industry (bus manufacture), but in the fact that it overpaid for a bus manufacturing acquisition some years ago. The burden of debt taken on to make the acquisition eventually strangled the company.

Chapter 5

Finding A Target

Selecting a business with all the right attributes to take-over may or may not be easy, it depends what you are looking for. Here are a few pointers

- **Make sure that you have good reason for targeting the potential acquisition. The reasons should be soundly based in your overall business strategy**

- **You probably already know the target, they are either competitors, or possibly suppliers or customers**

- **The owners have good reason to sell**

- **However, there are many sources of potential targets, yellow pages, the internet, trade journals, trade reps, business brokers!**

- **If you make it known to 'the trade' that you are looking for acquisition opportunities, you will probably get approaches from business owners who are interested in selling**

- **Many businesses will appoint an agent to identify possible acquisition targets, especially if this is geographical expansion into a new area.**

There are a few things I would particularly like to draw out of the above.

Make sure that you have good reason for targeting the potential acquisition. Acquisitions take place in two rather different sets of circumstances

1. In an ideal world you, the buyer will first have identified the desirability of an acquisition as part of your business strategy. Then you will have drawn up a profile of the type of business that you wish to acquire. You will have researched the market and drawn up a shortlist. You will have lined up your own resources in terms of management time and money. You will have approached the targets and one or more will have agreed to enter into negotiations

2. In the real world you get to hear about a business for sale, when your finances are already stretched, and your management team are already working 60 hours per week.

Do you enter negotiations?

Well maybe.

If you have a business strategy in place you will know whether this opportunity fits with your strategy or not. It has been my experience that a clear strategy has an almost magical way of opening up opportunities which otherwise might not be recognised. If you haven't got a strategy in place, then it is worth having a long meeting with your managers and advisers to consider where your business is going and whether this opportunity fits into that. If it does, then you must put the management and the funding in place and move heaven and earth to make it happen.

I have one story to illustrate the importance of strategic fit.

A client company was looking for an acquisition

- To increase profitability
- To better utilise fixed assets (property)
- To cover the cost of more skilled staff and to strengthen management.

After 18 months of fruitless searching two similar sized opportunities came along at the same time. These were similar in size and cost, but very different in nature. Target 1 had a solid business beautifully matched to our clients in geographic fit and 'bog standard' product range. Target 2 had a more profitable business providing niche products only partly overlapping our clients.

Firstly, we put together the numbers in 4 permutations

1. No acquisition
2. Target one only
3. Target two only
4. Take over both targets.

We were able to line up sufficient funding for any of these options and projections showed the highest profitability for option 4, similar profitability for 2 and 3, and lowest profitability for option 1.

This was important to know but the real decisions were taken using strategic criteria. Firstly, after much heart searching it was agreed that sufficient management resources did not exist to absorb both businesses, so the choice was narrowed to options 2 and 3.

The client had long ago identified the desirability of entering the more profitable niche markets, and this was a major objective of its strategic plan, therefore the decision was taken to go for the riskier option 3. As expected, this proved a difficult acquisition to integrate, but it has certainly helped our client to crack the niche market.

I have one last thing to say about choosing a target.

The owners have good reason to sell.

It is hard to know what is motivating another individual, but I would suggest that my confidence in a deal is nearly always aligned to how happy I am with the seller's reasons. If a 67 year old is selling his business to retire I am usually happy that we all know where we are. On the other hand, if a 35 year old is trying to sell me a business I am usually deeply suspicious of his motives.

Chapter 6

Approaching A Target

The English are traditionally reticent about this sought of thing.

But this is **not** a sales call, is it? You are approaching someone to offer them a large sum of money. In my experience very, few people object to such an approach if it is handled with discretion.

Of course, not everyone will know how to tell you that their business is not for sale politely, so you should be prepared for some abrupt responses.

If you are making a very specific offer to a selected target then it can be made by telephone, or in person, or in writing. If you are making a more widespread and general enquiry, then it will almost certainly have to be in writing. As far as possible such correspondence should be addressed to a named owner.

If you feel you don’t want everyone to know you are in the frame to make a takeover, you can ask your agent to approach potential targets.

Chapter 7

Valuing A Business

Valuing a business is more art than science, there are a great many factors to take into account, and there is no reason why two businessmen or two valuers should come up with the same answer (because they will perceive different factors to be important).

Furthermore, there are at least four different valuations that will apply to any company and they will all have some validity. These four values are

- Market Value
- Intrinsic Value
- Value to the buyer
- Value to the seller.

In this chapter I will explain

- What each of these is
- The strengths and weaknesses of each type of valuation
- How each valuation might be used.

Market Value

There is a definite market in some types of business. Like all markets, the market for businesses is driven by supply and demand, and demand in turn is usually driven by 'sentiment'.

Of course, there is a market for the shares of a listed company. And whilst this book has not been written for people who are looking at acquiring listed companies, it is instructive to look at the valuations placed on listed companies by stock markets. The main thing to observe is that valuations fluctuate wildly. There are good theoretical reasons for this, after all the theoretical market price is the net present value of expected future earnings, and a small change in expected rates of change can result in dramatic change in the net present value. But on the other hand, it is weird that a business with a market value of £5million today can be worth £50million or £500,000 tomorrow.

Markets clearly produce valuations that are highly erratic, irrational even. The classic examples of this are the bubble markets such as the Wall Street market prior to the 1929 crash or the 'technology' market for dot com businesses before the prices of many of these companies crashed by 90% and more in the new millennium.

Markets at our end of the spectrum can be equally unrealistic. Small cafes which are incapable of generating anything more than an average living for a talented proprietor working long hours, and which therefore have no intrinsic value, regularly exchange hands for a handsome premium, whilst profitable niche businesses often fail to find a buyer at all.

However, the market value is a useful figure to know. It tells us

- What price the vendor could probably get for the business from someone else

- What price we could probably sell the business on for, if our plans for it are not successful. (Although as with dot.com businesses market prices can collapse).

As with house valuation, obtaining a Market Valuation for a business is a bit hit and miss. The valuer must compare your target business with similar businesses in his experience (remember the prices at which deals are actually done are usually secret) and apart from a few restricted business sectors such as cafes and restaurants, pubs, corner shops and garages the market for businesses is usually extremely thin.

Intrinsic Value

Any business can be valued using the techniques of the traditional business valuation, as set out in the box. This technique thus has many things going for it

- It is solidly based in the actual historical profitability of the business

- The technique is widely and well understood and respected

- It can be applied to any business.

However, it does have a number of disadvantages

- Very many factors have to be rolled up into one **subjective** number – the multiple. The multiple must take into account, prospects for the business, market demand, required rate of return, risk assessment etc

- The technique tells you little about the target's prospects either alone or combined with your existing business.

At the end of the day all business valuation techniques are trying to put a present value on future cash flows. And as the future can never be foreseen with any degree of certainty all valuation techniques have a high degree of subjectivity. The problem with the Intrinsic Value technique is that all those different factors and uncertainties are wrapped up into one figure (the multiple) that may appear to be much more objective than it actually is.

The intrinsic value is a useful double check against the market value and can be a useful figure to know during preliminary negotiations. It is rare that a buyer paying more than the intrinsic value can make a success of an acquisition.

Doing A Conventional Business Valuation

Part 1 – The Adjusted Profit

The profit that goes into a business valuation needs to be adjusted, firstly to replace the owner's actual charges to the business with an estimate of a reasonable salary for the owner's contribution. Similarly, where the purchaser is not taking over the existing business debt, interest costs must be added back. Finally, where the purchaser is paying a different price for the fixed assets than that in the accounts it may be necessary to adjust the depreciation charge.

Unfortunately, it is not unknown to find small businesses for sale where takings have been skimmed or stocks are artificially low. The purchaser must decide to what extent he wishes to adjust for these items.

Part 2 – The Weighted Average

The accountant will adjust the profit for each of the last three years, then calculate a weighted average by applying a multiple of 3 to the latest profit, 2 to the previous year and 1 to the oldest year. The weighted average is 1/6 of the total of these three items.

If one year stands out as odd, perhaps because of a one-off property disposal, the accountant may decide to adjust that year's results before applying the weightings.

How much validity does this weighted average adjusted profit have? Well it tells us what profits the business has made in the past, and this is important. Presumably, the existing proprietors have been managing the business to the best of their ability, so all else being equal it tells us what they consider the business can make. But, whilst it is firmly based in reality this is a backward-looking measure, and business is all about the future!

Part 3 – Some Multiple

The multiple that is applied to the weighted average profit (before tax) is a single figure that needs to incorporate a great many factors

- Interest cost on the borrowings needed to buy the business (cost of capital – in the jargon)

- Risk of the deal going wrong

- Opportunity

- The need to pay back the purchase price out of future profits

- Market Forces

In short it is the multiple that contains all the subjective and future focused aspects of the valuation. Actual multiples achieved vary enormously from about 3 upwards, although I believe that the very low profitability of many businesses sold tends to skew the published figures.

Value to the Buyer

The value to the buyer is assessed by preparing two sets of future projections, usually about three years into the future (but large projects may have longer periods)

1. The future of our business without the takeover

2. The future of our business with the takeover

We look at the situation in three years and by playing with the purchase figures we can make an assessment of how much the target business is worth to us.

Ideally the buyer is looking for a target whose market and intrinsic valuations are significantly lower than the value to themselves.

Things which might make the business more valuable to the buyer (synergies)

- The buyer can take out costs by reducing the number of premises, streamlining production processes, getting better prices from suppliers and cutting overheads such as managers and accountants

- The buyer can cross sell into both customer banks

- The buyer can perhaps attain a critical mass which makes it possible to improve the quality of management, technology etc

- The buyer can diversify away from excessive dependence on one customer or from a declining market.

Most businesses will need to employ professional advisers such as accountants to help them prepare the projections which will allow a **value to the buyer** to be put on the target company, but to my way of thinking this is the most important figure for the buyer to know.

If the market price or value to the seller is greater than the value to the buyer, then it is unlikely that a deal can be done. Or to put it another way the selling price is likely to be such that the price of any deal would leave the buyer poorer not wealthier.

Value to the Seller

The value to the seller is quite difficult to assess. The seller is likely to have a good understanding of the value of future income flows from the business, of future prospects for the business, and perhaps of the market value of the business. He will be unlikely to want to sell if retaining the business provides significantly better income than anything that can be earned from the proceeds of a sale. In order to strengthen your hand in negotiations it is worth trying to find out not only the sellers asking price but also how he arrived at that figure.

Chapter 8

Raising the Funds?

Small businesses often struggle to raise finance for expansion, either for organic growth or for a take-over. However, in our experience a really well-presented business plan will usually find a willing lender.

Don't try to skimp on this, an investor or banker will not be impressed by someone who can't even be bothered to take the time to prepare a proper plan. If this part of the project isn't important to you then the lender will quite properly assume that other parts are probably being handled in an amateurish manner too!

Do not be entirely disheartened if you have already blown this, you can take a quality plan back to your bank having already been for a 'preliminary chat' or you can approach a new bank or other lender. A superb plan really does work!

Obviously, most readers will not be skilled in the production of business plans, and will need help from an accountant, banker or business adviser who does have this skill (see also note 1 below)

Who you approach for money, will depend upon many factors? Not least, how much you are borrowing and how much risk the lender is taking. Here is my simplified list of the best (and worst) sources of capital

1. Your own savings

2. Friends and relatives. If you do borrow from friends or relatives make sure that you document the terms carefully, it is a shame to fall out over this sort of thing. You need particularly to record interest and repayment terms.

3. Banks Loans. There are lots of (legal) ways of parting banks from money for acquisitions. I actually had one client who made a small acquisition by taking up 3 loan offers that landed on his mat in the junk mail. In general, secured lending will be cheaper than unsecured lending. Cheapest of all is usually a mortgage on your own home. Lending secured on business premises will be next. There seems to me little difference in cost between loans secured on other business assets and unsecured finance. As I say above, shopping around with a good business plan will usually find backing for a viable proposition

4. Venture Capitalists, Business Angels, and other investors. Unlike banks investors will want to take a stake in your business. Thus, they have a stake in your success with all the advantages and disadvantages that that implies

5. Factoring and Confidential Invoice discounting. The bank either runs or closely monitors your sales ledger, therefore its costs are much higher than with other kinds of funding. You pay this cost and I have seen many small deals that are frankly ridiculous. Whilst it is an option for rapidly growing highly profitable business, for most businesses this option is to be avoided at all costs!

Note 1. The British Venture Capital association publish an excellent Guide to Private Equity, which contains an excellent section on business plans and is available free on www.bvca.co.uk

Chapter 9

Negotiating

Some people love negotiating, some people hate it, all I can say is that some people who fancy themselves make a real fist of it.

Don't forget that according to KPMG 'two thirds of takeovers by quoted companies lose money for the shareholders of the expanding company!'

It seems that buyers often get carried away with doing the deal and get suckered into paying over the odds. We don't want to get caught in that trap so we need to know how much we are prepared to pay and **<u>to be prepared to walk away</u>** if we can't get the target within that budget.

As a buyer we have a lot of negotiating advantages

- The seller and his family will be looking forward to spending all that loot
- The employees will switch allegiance from the person who is selling them out to their probable new boss – if they find out – and I'm assuming they will
- The bank will only lend us what they assess the business to be worth so we simply can't raise that extra money that the seller wants (that's what we tell them anyway)
- The due diligence will find all sorts of problems about the target business, which will tend to reduce the price

But the vendors will also have, or try to create, or pretend to have, some advantages:

- They will try to get more than one party interested in buying, they will try to set up an auction
- They actually know the business that is for sale
- They will usually be able to call off a deal without too much harm done to the business
- They have got only one thing to focus on – the price.

There are a lot of topics to negotiate about, Chapter 10 is a list of topics to consider when buying a business. Particularly crucial is the pattern of payments. We will usually want to defer some element of the payment as some kind of protection against breach of contract by the vendor. Preferably we will have a formal link between future performance and total amount paid.

The vendor will of course resist this as much as possible, he will quite rightly argue that he has no reason to be dependent upon your future performance for his money. Actual deals struck usually depend upon the nature and relative size of the deal

- Small deals are usually for cash up front (Small relative to the wealth of the parties)

- Larger deals usually have some element of deferral; this is especially true if the vendor is staying on after the deal is struck

- Asset backed deals are more likely to be for cash than purchase of goodwill.

There are two major advantages to the purchaser of deferred payment

- Firstly, it means having to borrow less money up front and thus reduces the interest bill. Whilst this may make relatively little difference when you can borrow at 6% it makes a big difference if borrowing rates rise to 12%. Even at 6% £100,000 deferred for a year saves £6,000

- Perhaps more importantly, deferred payment offers some protection against certain types of risk. For example, if the vendor sets up a new business in competition and in breach of contract and you are holding part of the purchase price back… well he is in breach of contract so you can counter charge for the cost to you of his breach. Normally, a claim under a warranty would be a waste of time, but as you are holding on to the money, this time it is likely to be very effective.

It is however, better to have a formal link between some quantifiable measure of the goodwill such as

- The first two years profits, or

- The first two years sales

to decide how much is actually paid. This mechanism will tend to ensure that the vendor works really hard to make the deal a success and thus improves the probability of success. Also, it lays off much of the risk - if only 60% of the business transfers to you only pay 60% of the price. Compare this with the situation in which you have a straight forward deferral, the client sticks to the letter of the contract, but the business was never going to be as successful as he led you to believe. You are morally and legally obliged to pay the full price.

Case Study

Over the years we have been involved with several sales and purchases of service businesses. These tend to transfer on some multiple of turnover (not very sophisticated) rather than profit, but they are usually paid in stages over two years. This staging is a simple but effective from the buyer's point of view. One friend of mine bought a block of business which proved to be not as advertised, several of the clients transferred had already left the vendor, and several others were not 'as advertised'. Various breeches of contract took place and, in the end, only the 50% first instalment was ever paid. The staging protected the buyer from a possible massive loss, and the fact that Due Diligence was totally inadequate.

On the other hand, too much dependence on future performance can ruin a deal for the vendor. Buyers may mistreat customers or even 'cherry pick' safe in the knowledge that the cost of the lost business is being borne entirely by the hapless vendor – a despicable practice.

Similarly, a client of mine with a 3 year work out deal believed that he had got top dollar, but when ill health struck him (probably because of the stress of the sale) he was unable to contribute as planned and only received a fraction of what he expected.

Finally, a couple of warnings and a case study. Don't invest too much of your own commitment, self-confidence or emotions on doing the deal. Sometimes a sensible deal simply cannot be done, and you are better to walk away. Secondly, there is no guarantee that the other party will act rationally. They may have personal, family or business agendas or attachments quite beyond your reckoning. They may have set themselves limits or targets that you are quite simply unable to match. Or they may simply let their hearts rule their heads.

Case Study

These events happened a few years ago and I still don't know what to make of them!

My client became aware of a very compatible business for sale and approached the vendors. Negotiations were difficult, as we simply did not feel that we could trust what we were being told by the vendor. None-the-less we performed a quality Due Diligence and found bank funding for a £900,000 deal largely on the strength of our business plan – asset backing was very thin. The client business had not actually been that profitable, they had suffered several cycles of 'investing' in growth followed by cut backs to restore profitability (as per chapter 2), and we valued it at £600,000 at the most. However, in trying to get inside the client's mind we had formed a very strong opinion that they needed at least £900,000 for the other projects that were the reason for the sale. We therefore offered two options £600,000 for the business for sale or £900,000 for an expanded deal.

The vendor exploded and instead of buying the business we found ourselves evicted from their premises in quite ugly circumstances. Our reaction was one of confusion mainly. Our astonishment was compounded when only three weeks later the entire vendors business was put into receivership!

It is hard to guess why the vendors preferred receivership to £900,000, perhaps they thought they had other options, but I have a sneaking suspicion that they could not bear the thought of being out negotiated by a couple of provincial innocents (as they perceived us to be).

I have done a bit of research for you on what the experts say about successful negotiation. Here is my precis

- Plan. Before you go into the meeting know what are 'must have' issues and what are 'would like to have' issues

- Research the other side. Find out what they want, what are the strengths and weaknesses of their position. What are their 'must have' issues and what are their 'would like to have' issues

- During negotiations look for areas of common ground, if things get bogged down, go back over the areas of common ground

- Don't aim for a win-lose outcome, aim for a win-win outcome. In almost all small acquisitions the ongoing support of the vendor will be a great help. If he thinks he has been shafted, then you will not get active co-operation and he may well try to undermine you in future

- Be a good listener

- Take notes, especially of points that have been agreed

- Make a big deal of every concession that you make.

Good luck!

Chapter 10

Procedures

Negotiations are by their nature a bit chaotic and procedures may or may not be agreed and kept too. I have never known two deals that were alike. None the less all takeovers follow a more or less set pattern

- Both sides sign ***confidentiality agreements***
- The purchaser attempts to extract preliminary information from the vendor, information about customers, products, cost structure, past profits, human resources, properties and other assets etc
- The vendor will want some evidence that the vendor actually has the resources in place (money) to make the takeover
- There may be a ***heads of agreement*** prepared
- There may be an ***exclusivity agreement*** signed
- There may be a more detailed investigation of the target company by the purchaser – called a ***due diligence*** exercise
- Finally, somebody will have to put the deal down on paper and eventually the deal will be signed and the price paid
- The vendor can now go away happy but for the purchaser there comes the difficult task of integrating two businesses and making the deal pay.

A **confidentiality agreement** assures the vendor that the buyer will respect the confidentiality of any information made available by the vendor.

A **heads of agreement** sets out in rough terms what has been agreed and the basis upon which further work such as due diligence and fundraising progresses**.** It is a simplified draft contract – but it is still 'subject to further negotiation'.

An **exclusivity agreement** commits the seller not to talk to other potential purchases for a short period, whilst the buyer conducts due diligence and secures the funding, for example.

Due diligence is usually carried out by outside experts, part of your team of advisers, most business people want some recourse to the PI policy of the adviser I suppose. But this doesn't have to be so and the more research that is carried out by the team who will actually be running the business post acquisition the smoother the integration process is likely to be.

Chapter 11

Do We Use A Lawyer?

This is by no means a clear-cut question. If you are conveying land as part of the deal you will most certainly need to use a lawyer, if it is a large or complex deal, or if the deal is acrimonious you will need to use a lawyer. But, if it is a small deal, if the deal is friendly, if broadly you trust the other party and if things are not too complex then use of lawyers should be carefully evaluated. Here are some of the factors to consider.

Why to use a lawyer?

- You will be confident that you have bought what you have paid for
- The lawyer will know of many traps for the unwary and will work very hard to protect your interests.

Why not use a lawyer?

- Lawyers **costs** can be disproportionate to their contribution to a small deal
- Lawyers have their own language, and their training leaves them seeing the world in a different way to the rest of us. In consequence the deal in the legal documents is often very different to the deal that you instructed them to do. This is very frustrating for both sides and I have known done deals to collapse because of the failure of the lawyers to document the agreed deal as instructed. I have also known businessmen made ill by the **stress** of this process
- Documenting a deal in legal terms, carefully covering every angle, and in particular the inevitable process of dispute between the two sides, is always very **time** consuming. If time is of the essence, involving lawyers may not be possible.

If you decide not to use lawyers, then at least document what you have agreed, and both parties sign the agreement. (you need two copies – one for each side.) Not only will the courts respect a signed agreement as a record of the contract between both parties, but both sides tend to have different recollections of what was agreed, a written document can often resolve an argument before the parties fall out. Honestly!

I have four useful case studies that exemplify the points made in this chapter.

In one case a client of mine was looking at a third acquisition in as many years. This was a relatively small deal. The client carried out his own due diligence and reckoned that the assets he was buying easily covered the cost of the deal. We were able to minimise the risk to us by buying the business out of the target company and by negotiating 20% of the proceeds to be delayed 12 months. The client wanted to get the purchase and the 40% capital allowances into his financial year. We wrapped up the deal in a morning between 5 of us – no lawyers.

The second example is from a deal I did myself. I had always been astonished by other peoples' inability to recollect what they have agreed to until it happened to me. A guy I bought a small business from asked me for a £1,000 bonus as agreed. I had no recollection of any such amount, but I liked the guy, so I make some non-committal noises and went to check the contract, largely written by me. He was dead right. For me it was a chastening experience, although I paid up with good grace and we remained friends.

The moral I draw out of this is that our memory plays tricks on all of us, so get it documented.

A client was approached by a competitor that had secured funding to build up his business by acquisition. We liked the guy who made the approach and as my clients were approaching retirement age quickly agreed a deal. We got on fine with the Accountant who carried out the Due Diligence and the deal was passed to lawyers.

Four weeks and £12,000 of legal fees later my clients concluded that they were never going to get the deal that they thought that they had agreed, and they withdrew from negotiations

A client of mine concluded that changes in his industry made a trade sale imperative. Agents were employed and a deal struck with a national chain. After 8 weeks of legal wrangling my client was hospitalised by heart disease from which he has never fully recovered…. Of course, we don't know that it was stress that triggered the heart disease…

I deal with lawyers a lot and most of them I greatly respect. I was wondering if I could summon up enough courage to ask one to reply to this rather disparaging chapter, when a booklet from a firm that I hold in high esteem arrived in the post. So, with full acknowledgement of their copyright etc. here are a few extracts from the booklet 'Buying and Selling a Business' published Steeles (**www.steeleslaw.co.uk**) along with Business Link for Norfolk.

The Hornbeam Guide to Successfully Buying A Business

Buying a business is a significant transaction; perhaps the largest deal of your life. The issues at stake are often technically complicated.

Proper legal advice at an early stage is essential in any major transaction for two reasons

- To ensure certainty – are you clear exactly what it is that you are buying
- To protect your investment against unexpected liabilities

Uncertainty or taking matters on trust can often end up expensive.

The booklet Buying and Selling a Business is, I believe, free from Steeles or Business Link for Norfolk and is well worth reading.

Chapter 12

Doing A Deal

Once the negotiations are over, we should be able to document an agreed deal. This should contain the following elements

1. What is sold

2. Any liabilities that are to be adopted by the purchaser

3. The mechanism by which the assets and liabilities are transferred (especially goodwill)

4. The price

5. When and how payment is to be made

6. The continuing involvement of the vendor.

Taking these components in order.

a. It is fundamental in selling a business (as in selling a property) to accurately describe what is sold

For example, you may buy the <u>shares of a limited company</u> (this can be a very easy and cheap way of transferring contracts, assets and especially goodwill – but you can also buy a whole load of liabilities you didn't know about. Old corporation tax or VAT liabilities, pension liabilities, litigation relating to product failure etc. etc. A due diligence may find these liabilities, but it may not.) or you might prefer to buy just the assets that you want from a company (This allows you to choose just the assets that you want and to avoid liabilities both known and unknown – but it can cause confusion and problems for customers and staff just at a time when you want to get these parties onto your side).

Even if you are buying from an <u>individual or partnership</u>, you must negotiate whether you take over all the stock (what value do you put on it), whether you collect the debtors (if so who suffers any bad debts), who settles the creditors, including major items such as VAT. These items often get little attention after the main negotiations to value goodwill, and fixed assets.

It is interesting to consider here what are the main assets that form the basis of most deals

Goodwill: This is the value put on the ability of an existing business to generate profits over and above the proprietor's reasonable salary. Goodwill is the financial recognition of successful business systems.

Lease Premium: Many small businesses only make a profit because of their favourable location. This may be recognised by a lease premium.
Freehold Property: Freeholds may be an essential part of any business deal, Freeholds owned by individuals or Pension Funds will have to be conveyed (by lawyers), Freeholds owned by Limited Companies can be transferred by transferring shares in the company.

Equipment: Some combination of Operating Equipment, Fixtures and Fittings, and Computer Systems underpin many small business deals. As mentioned elsewhere, it is often better value for money to buy the equipment of an established business than to start from scratch.

Stock and WIP: Most business deals provide for stock to be counted and valued on the day of the sale, otherwise a proprietor may sell off the stock before selling the business at an agreed price – but beware agreeing a price for the business then being asked to pay for the stock at valuation on top, build in estimated stock at cost as part of your total offer.

Debtors: Generally, in small deals each party will collect their own debtors, but if you buy shares in a limited company, you will have to buy the existing debtors. In a business to business sector debtors make a difference to cash-flow, if you don't buy the debtors, you don't get any receipts for the first couple of months whilst your own debtors build up. You must borrow to finance this.

Cash: Only if you buy shares will you have the option of buying existing bank balances – well at least cash is easy to put a value on.

b. Liabilities

With the assets will come various liabilities. It is as essential to document how the liabilities are to be apportioned as it is to document how the assets are to be apportioned.

Perhaps the easiest things to deal with are known creditors (suppliers) and loans (such as bank overdrafts). There are two basic approaches. Either

- the buyer just buys the assets that he wants, leaving the seller to settle the liabilities, or

- the parties arrange for a balance sheet to be drawn up on the date of the sale and for the price to vary £ for £ from an expected valuation.

There are several other classes of liability that need to be considered.

Firstly, every business will have ongoing liabilities, for example potential redundancy costs and product warranty costs. If there are to be redundancies as part of the business transfer the sale document needs to establish who makes and pays for the redundancies. If there are pre-existing legal actions against the business or if there are likely to be significant warranty claims the document must specify which party is going to pick them up.

Similar considerations apply to various tax liabilities such as PAYE, VAT and Income Tax.

However, more problematic are the unknown or undeclared liabilities. These may be for mistakes with VAT or other taxes, product warranties, legal or regulatory matters, or onerous contracts. The purchase document should specify who picks up any unforeseen costs, or at least on what basis they will be allocated. For example, if you buy only the assets of a business you would not expect to pick up any liabilities, but if you continue the employment contracts of the staff, if you continue with the PAYE or VAT references of the previous owner, or if you buy the shares of a company, you might find yourself inheriting some very large liabilities. You must ask for an undertaking from the vendor to shoulder the cost of any unknown liabilities that arose prior to the sale. However, these warranties are of little use unless you defer some of your payment, out of which warranty claims can be deducted.

c. The mechanism by which the assets are transferred.

For physical assets the mechanism for transfer is usually straightforward. Land (buildings, leases etc) must be transferred by conveyance (you will need a lawyer). Other physical assets are usually listed in a schedule to the sale document and are transferred by delivery – in layman's terms the purchaser takes physical control of the assets at the appointed time. Intangible assets, and goodwill in particular, are more complex. The thing to do is just to organise the deal as a series of steps to take control of the goodwill

- You write and despatch a mailshot from the vendor, signed by the vendor, to all of the key players, particularly customers and suppliers. The letter must state that he is retiring, that he is selling the business to you, and that he is convinced you will offer excellent service, as well as names, dates and contact details

- Arrange for the telephones to be diverted into your offices, or for your loyal staff to take control of the switchboard. Similarly, arrange for post to be diverted to your offices or for your loyal staff to open the mail. Do not let the vendor retain the key customer contacts, direct the customers toward new contacts amongst your own loyal staff

- The sale contact must contain a non-competition clause or clauses. The vendor must not accept any work from any customer of the business for a period of three years. The vendor must not set up in competition within a 20-mile radius of your office for a period of 3 years…etc. The more onerous the clause(s) the less likely it is to be enforceable in a court of law

- The contract should provide for the vendor to work actively to assist with the smooth transition of the business, for a period of your choosing, often the vendor will be retained as a consultant during this period

- During negotiations and after the sale you should miss no opportunity to win the loyalty of key members of the vendor's staff

- Last but not least, the contract price should contain a success element that incentivises the vendor to make a success of the business transfer. This can take many forms, for example a percentage of the business retained after two years or a percentage of the business profit for each of the first two years – but some incentive to the vendor is essential.

d. The Price

As referred to in various places above the price is quite a complicated issue. There are a number of problems

- You cannot tell what assets you are getting or what liabilities you are inheriting until after the deal is done, in a trading business these things vary constantly, but if you agree a fixed price the vendors have an incentive to remove as many assets as possible before the transfer takes place

- If you are buying a business based on what you believe about its potential future profitability, you may be reluctant to agree a fixed price now.

- The answer to these problems is to introduce some variability into the contract. Here are some options with regard to the assets and liabilities.

- Based on what you have been told you agree to buy the company for £500,000 but this is based on the working assumption that on the date of acquisition the net asset value of the company will be £250,000. You agree to have the auditors prepare a balance sheet of the company on the date of acquisition and to vary the purchase price £ for £ as the audited net asset value varies from £250,000

- You agree to buy the leasehold for £20,000, the goodwill for £10,000, the equipment per the agreed schedule for £30,000 and the stock at valuation

- Here are some options with regard to goodwill

- You are buying a £60,000 customer base. You agree to pay £30,000 now, and 100% of the value of the retained business less £30,000, in twelve months' time

- You are buying an existing business making £100,000 per annum adjusted profit before tax. You agree to pay £50,000 now and 25% of the adjusted profit over each of the first two years.

Be warned though, the vendor will fear

- That you are trying to rip him off

- That you will make a hash of running his company.

Therefore, he will want 100% cash up front.

e. When and how payment is to be made

To recap, you will want to defer payment

- Until you can accurately assess what assets and liabilities have been transferred

- To lay off risk of the business not being as successful as expected

- To hold as bond against warranties given by the vendor

- To incentivise the ongoing co-operation and good behaviour of the vendor

- To help with your cash flow and reduce your interest costs.

The sale document must set out clearly what you finally agree.

f. The continuing involvement of the vendor.

People hold strong views about maintaining a relationship with a vendor, many people think that from day one the vendor should be shown the door and never allowed near the business again. This might be true in some cases, for example if the vendor is fundamentally dishonest, or if radical changes are needed which the vendor is known to oppose, but in many cases there are good arguments for retaining the services of the vendor

- To make introductions and maintain the continuity of personal **contact**

- To maintain access to technical and specialist knowledge

- To maintain the vendors commitment to the success of the enterprise.

Whether this works or not largely depends on the character and goodwill of the parties to the contract.

If you do decide to retain the services of the vendor, his terms of employment (title, hours, remuneration, duties etc) need to be set out in the sale document.

Chapter 13

Making it Work

Buying a business is great fun. It is very exciting, and it should help to make you much wealthier. But doing the deal is the precursor to much hard work. Without determined implementation the deal will not enhance your business at all. Here are some of the things that you may need to do

- Apply the things that you determined to do as part of your business planning/due diligence/negotiating
- Cut those loss-making activities now, there will never be a better time
- Meet and wow all the main customers, if necessary, get new contracts signed up
- Integrate the customers into your business systems, make them your customers
- Pay attention to the staff, arrange to train their staff in your systems, ensure that you have loyal staff in key positions, mix the new staff into your organisation so that there is no chance of uncooperative cliques forming
- Integrate systems. Choose the best systems from each organisation. Train your staff and train again
- Eliminate waste and duplication, take the chance to exploit greater volumes to increase efficiency and to cut costs wherever you can
- You may be able to leverage your gains by cross selling (selling new products or services from the acquisition to your old customers as well as selling your products or services to the newly acquired customer base).

With effective implementation an acquisition will enable you to drive down unit costs, improve margins on sales, improve the professionalism of everything that you do, and most of all it will make you wealthier.

Done without adequate planning, without careful implementation, and indeed with real understanding, an acquisition can quite easily leave you with excessive overheads, massive borrowings, poor staff morale, poor customer service and a declining customer base.

One area to beware of is ‘cross selling’. Salesmen in particular are liable to become very enthusiastic about the possibilities of cross selling. It is an accepted truth of marketing people that it is always easier to sell more to existing customers than it is to win new ones.

Well, in my experience there are other factors that make cross selling more difficult for small firms than they envisage.

In particular, salesmen are usually fully occupied servicing their existing customers and finding time to systematically target the new client bank is not usually achieved (larger firms would set up a team to do this and thus would have greater success). Also, the customers, far from falling over themselves to buy the new products or services have already established close relationships with alternative suppliers, a high-pressure sales drive causes considerable tension and may actually lose some existing customers. So, if you are looking for cross selling opportunities from your acquisition, develop your marketing plan with care, allocate sufficient resources to make it happen, and review the outcomes constantly. There may be some 'low hanging fruit' but there will be plenty of thorns and fallen branches along the way too.

Case Study – Business Culture

I have read many times about acquisitions being 'difficult' or 'unsuccessful' because the acquired business has such a different 'culture' to the parent but have never seen a detailed exposition of what these cultural differences are. I came to suspect that 'cultural differences' were code for the acquiring management botching the integration processes. However recent personal experiences caused me to refine my view.

My client had developed quite a successful business retailing IT equipment and some software products. This is one of the world's most competitive markets and to survive they had developed ways of working which drove costs out of every process. Buying, delivery, support, and even selling were efficient and cost conscious.

Non-the-less because of the fierce competition margins in this business were painfully thin and the owners were searching for a way to get into higher value-added fields, such as systems development, implementation, and integration. An opportunity arose to purchase a small contractor with an excellent reputation and an existing blue-chip customer base. The opportunity was taken, and I was face to face with a major culture clash

- The contractors were quite used to working all night to sort out a problem for a client, the acquiring company had a 'no overtime' policy
- The contractors were proud not to bill until the contract terms had been met down to the smallest item. The acquiring company was fixated on working capital control, with a real abhorrence of work-in-progress
- The top salesmen, analysts and programmers at the contractor had better salaries and

bonuses than the directors of the acquiring company!

Oops!

So here is a list of a few things to watch out for which may lead to a culture clash if the acquirer and the target have adopted different strategies

- Big differences in salary scales
- Big differences in bonuses
- Big differences in supervision practices, working conditions etc
- Big differences in what is charged for and what isn't
- Big differences in billing practices
- Big differences in customer or product support
- Big differences in supplier relations

The point is that the strategy adopted by the acquired company may be fundamental to success of that business. Applying the 'culture' of the acquiring company may well destroy the successful 'business model' of the acquired business.

Case Study

Thus for example retail banks with their salary scales and bureaucratic procedures, find it very difficult to successfully manage investment banks with their stratospheric bonuses and deal making culture. Jack Welsh in his autobiography 'Jack' describes how GEC found investment banking to be an industry sector completely incompatible with GEC's management culture.

Case Study

A construction company took over a smaller rival. In common with most competitors at that time the acquirer pursued an aggressive policy of holding down prices by putting everything out to tender and accepting the lowest bid. The target company had a policy of putting work out to tender (to keep any eye on prices) but only placing work with subcontractors with which it had developed close working relationships. In consequence the target company had an enviable reputation for bringing in difficult jobs on time and on budget. As soon as the acquirer started to enforce its' policy of 'lowest tender wins' jobs started to go wrong, costs mounted, disputes with suppliers and customers multiplied, key staff left, and before long the acquired business was all but destroyed.

Case Study

Bloggs was a successful little IT support business, two or three engineers in vans spent their days visiting a bank of first-rate clients sorting IT problems. Bloggs policy was to charge a small annual retainer to cover a routine annual service and software health check. One engineer spent all his time doing the health checks (and selling lots of additional software, hardware and services) the remaining engineers doing the fire-fighting, installation, upgrades etc. This business was taken over by a much bigger rival. They insisted that all customers pay an annual support fee (calculated by reference to number of machines, hours of call out etc). Unsurprisingly, half of the customers were lost in the first year. These customers were prepared to pay for the hardware and services that Bloggs delivered but had no intention of paying upfront for hardware and services that the new company might well fail to deliver at all!

Chapter 14

Paying Your Advisors

This isn't a plea for more money, it is a plea for common sense!

Perhaps it is not surprising that so many city deals destroy value for the shareholders, when one considers that the professionals involved are almost always incentivised to make the deal. The 'success fee' is not for saving the shareholders £100 million or whatever, the 'success fee' is for getting the deal done. This is just astonishing when you think about it.

So, my plea for common sense is this. When you are selling a business as with any asset, by all means agree to pay your advisers on commission basis. Incentivise them to get as much as possible, for you. But when you are buying a business you want to incentivise you professionals to get the best possible deal for you. You want them to identify and to tell you about the problems. You want them to tell you when the sensible thing to do is to walk away. You want them to help you get the best possible price and the best possible deal. In most cases it is not possible to design an incentive scheme that aligns to your own interests, so pay your advisers for the work they do, usually by the hour. But don't give them an incentive to waste your money, or to give you bad advice.

Chapter 15

Why Now Is A Good Time

Although I am an accountant by profession, I have steered well clear of taxation up to now.

But now is an exceptionally good time to be buying and selling businesses in Great Britain from a tax point of view. The chancellor wants businesses to change hands, so that assets move into the hands of successful entrepreneurial managements who will improve efficiency and the competitiveness of the British economy. So, there are some exceptional tax breaks.

At the time of writing, for vendors, the Capital Gains on the sale of a trading company owned more than two years will not usually exceed 10% of the proceeds and many cases will be significantly less (because of the base cost, indexation and the annual exempt amount for example). This compares rather well with the 40% higher-rate-tax that most successful vendors pay on their income.

For purchasers, intellectual property (which includes goodwill) can now be depreciated (attracts capital allowances) which reduces the tax on an acquisition whilst loans are being repaid and is generally very attractive.

Actually, taxation can make a crucial difference to the viability of a transaction. All aspects of Taxation should be considered

- Tax rates on (increasing) future profits
- Stamp duty on share or property transactions
- VAT aspects of everything
- Capital Gains Tax on the sale
- Capital Allowances and allowable amortization of goodwill on purchased assets

And as tax rates and rules change at least once a year, you want a really good accountant to advise you on the tax aspects of even quite small transactions.

At present most of the tax advantages favour buying assets rather than shares (as do the business risks), but for the seller the tax advantages favour a share sale (as do the business risks), which makes ‘negotiation’ difficult and tax advice during negotiations essential.

It is also a good time to be buying a business because there appears to have been a seismic shift in both the level and variability of interest rates. Now it looks reasonably possible to borrow £500,000 over 10 years at 6%. A generation ago we might easily have seen those interest rates move to 12% or more over the course of a year, this was often enough to destroy the viability of an otherwise sound investment.

Chapter 16

Case Study

David and Julie Bloggs have been in business for many years. 10 years ago, David's haulage business was put into receivership. Since that time the couple have slowly built up their short and long term commercial vehicle hire business Bloggs Commercial Hire Ltd. David and Julie have an exceptional relationship with their accountant and together they have maintained a rolling five-year plan.

The family have three children although only one daughter works in the business. They have several first class managers. The nub of the strategy is to continue to create opportunities for their daughter and their managers by steady expansion of the business, they also intend steady growth of their own income and hope one day to sell all or part of the business – for the right price. They are conscious that a proven management team could one day head up a management buyout.

The Bloggs have been looking for a suitable acquisition in a neighbouring town for nearly two years. They have profiled the target as

- Owning a high profile depot in a nearby town
- Having good reason to sell
- Being in a similar but not necessarily identical business.

Having carried out considerable research

- Desk research through yellow pages and various directories
- Searching companies house data by type of business and geographical area (a marketing agency did this for them)
- Telephone research, by talking to customers and suppliers in particular.

Their advisors then sent a mailshot to all businesses identified as potential targets, two of whom responded. Further research showed that one had quite unsuitable premises and the other was more interested in getting a free business valuation than in actually selling up.

The trail having gone cold the Bloggs decided to develop the business anyway. The manager of the head office depot was recruited to the Board, and a search was commenced for suitable premises for a second depot. The manager would establish and build up the new depot whilst the assistant manager would be promoted to run the head office depot. The daughter would assist with the development of the new site.

A redundant petrol station is eventually purchased, although disaster is only just averted when legal due diligence uncovered numerous problems including contamination and planning disputes causing the first site chosen to be abandoned. Refurbishment work, the purchase of new stock, and the expansion of debtors tied up far more money than budgeted and for the first time in five years Bloggs Commercial Hire Ltd has cash flow difficulties. These difficulties are exasperated when the first quarterly management accounts after trading commences at the new depot show a substantial loss. The Accountant and Management do considerable work to ascertain the breakeven point for the new depot. Then looking back over the build up of the head office depot they estimate it will take 2 years to reach breakeven on the new depot and four or five years before a reasonable return on capital can be achieved.

Whilst the family are prepared to absorb the reduced profits for the next two years the cash flow forecasts show that a substantial increase in banking facilities is required. The bank manager seems very concerned by the falling profits and increasing overdraft and is extremely reluctant to offer increased facilities!

Into this mêlée comes a call from an agent acting for the owners of a particularly fierce local competitor. 'Would Bloggs like to buy their business?' Reluctant to admit his own difficulties or to miss an opportunities Mr Bloggs expresses an interest and calls a council of war. His accountant sends off confidentiality letters and asks for five years accounts; his daughter sets off to have a look round the two depots. They find that although it has grown rapidly the competitor is not very profitable, and quickly determine that it is only achieving hire rates about 90% of market rates. Most excitingly it has two freehold depots, one only two miles from Bloggs' new depot. Due diligence reveals that the target company has some good mechanics and that the profitability has been depressed by the owner's sons 'putting their hands in the till'. The owner has lost interest as he has also built up a very successful property development business.

The Bloggs team prepare business plans based on

- No involvement of the vendor or his family from day one

- The number two site and the nearby competitor's site are amalgamated, and the surplus site sold off

- Prices are raised to market rates with an allowance for an initial 20% fall in business and corresponding 'rationalisation' of the hire fleet and employment.

The team are astonished by the resultant figures, which show that the combined group is immediately three times as profitable as Bloggs Commercial Hire Ltd ever was with one site. The only sticking points are the price and finding the money.

The competitor is happy to take the value of the sites plus the net value of the assets after liabilities. As this is about 50x his recent book profits he accepts that there is no goodwill to sell. The Bloggs team enter these figures into their model and quickly agree the price. The vendor agrees to a one month non-compete contract whilst the Bloggs raise the money.

The Bloggs Commercial Hire Ltd bank manager has already made up his mind to reduce his ‘exposure’ to the company and is frankly dumbfounded when they come to him with a proposal to borrow a further seven figure sum. Fortunately, the team have foreseen this reaction and have already arranged appointments with three other banks. The proposal is well thought out and well presented; fortunately, there is extensive asset backing, and many opportunities for other parts of the successful bank (commercial vehicle finance for example), so two banks come back with positive responses. The team assess the offers and the new bank is appointed.

The Bloggs team would dearly like to buy the assets out of the company so that they do not inherit liability for any of the suspected illegal behaviour of the vendors, however the vendor is only prepared to sell the shares of his company, and it is clear that the very low capital gains tax rate is critically important to him. The Bloggs team are also deterred by the stamp duty costs of transferring the two sites.

The Bloggs team don’t trust the vendors and have high respect for the solicitor who saved them from disaster only recently, so the deal is tied up by solicitors.

A share purchase deal is done. The Bloggs team immediately set about implementing their plan. Whilst the daughter takes control of the third depot, working hard on winning over employees and customers alike, the manager of the second depot has the job of merging the adjacent depots. The spare depot and surplus plant are sold off by Mr Bloggs quickly repaying nearly 1/3 of the bank borrowing. The third depot is sold into the Bloggs Executive Pension Scheme further reducing the company’s bank borrowings. The plant (and attaching Hire Purchase agreements) and employee contracts are transferred into Bloggs Commercial Hire Ltd, the creditors are paid off and the target company is struck off.

12 months later the scene is transformed, the company have three profitable depots, relatively little borrowing, a supportive bank, and is achieving market rates or better for its hires.

The Hornbeam Guide to Successfully Buying A Business

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