



Acquiring a business

“ Most companies
are for sale, given the right
offer and timing. ”

“ Don't become sidetracked by so called 'good opportunities' ”

Has the time come for you to think about alternative ways of growing your existing business?

If so, the acquisition of another business may complement organic growth and enable you to expand more quickly.

There are on average 350 acquisitions made within the UK every month, making up almost half of those recorded throughout Europe. The size and complexity of these deals varies massively. The average deal size of acquisitions in the UK during 2008 was £110 million, lower than the £148 million in 2007. Of the 4 million-plus acquisitions completed during 2008, nearly 93% were under £50 million in value and involved owner managed businesses *

Should you decide to acquire a business you need to think seriously about your motivation, as this route is costly as well as risky. You should have a clear strategy in mind and ensure you stick with this throughout the process. Don't become sidetracked by so called 'good opportunities' if they don't fit well with your existing operation and provide the opportunity to add value. The risk may outweigh the reward.

* Source: Corpfm,
Monthly M&A Review.



In the long run will an acquisition increase the value of my enterprise as a whole?

It is common for businesses to expand via acquisition as well as grow organically.

By amalgamating the operations of two businesses it can offer great benefits for both, such as:

- **Increase in sales**

It may be possible to cross-sell your products to your target's customer base, and vice versa. Look for businesses that complement your product range and widen access to customers.

- **Improving market presence**

Acquiring a business within the same market will immediately increase your presence. Larger businesses are less risky and a bigger, better brand conveys confidence to your customers. You may also be able to exert more power on suppliers and reduce your cost base or improve credit terms.

- **Access to assets**

Your chosen target may have a number of specialised assets you require use of. Alternatively they may have licences or patents that you cannot access yourself. Assets also include the employees. A good, skilled work force could be lacking in your sector, so acquiring a company with this already established could be a vital way of keeping your business running in spite of a skills/labour shortage. Similarly a shortage of physical capacity may be constraining your growth. Spare factory capacity could be a critical plus factor.

- **Defence strategy**

Acquiring a competing business may sometimes be a good strategy to reduce competition. In doing so it may allow you to increase sales as well as adjust prices where these were previously restricted.

- **Diversification**

Acquiring a business that provides a different service or product could reduce your business' risk to a downturn in a specific market. It is a common strategy for seasonal businesses so they are able to generate income all year round.

- **Cost savings**

Combining common functions between two businesses can significantly reduce the overall cost base in relation to turnover. Head office, accounting, warehousing and purchasing, are examples of areas which could yield possible savings.

- **Geographic expansion**

Your business may currently operate in a limited geographic area. Acquiring another business may enable wider UK or overseas markets to be covered.

- **Vertical integration**

Sometimes, acquiring a supplier should be considered. This could offer benefits of greater stability of supply, quantities or prices, better control over quality in addition to improved margins.



Should I consider any other issues?

Be wary of any negative implications of your strategy. Employees are not tied to a company and cultural mismatch is one of the key areas that leads to a failure of acquisitions to generate value. They may choose to leave after the transaction for various reasons, unless they are key employees tied into the deal.

Cultural clashes between staff or procedures may fuel this situation and can be a long and costly process to avoid. Employee incentivisation methods (bonuses, share options, shares etc.) can be key to a smooth ownership transition.

Funding required for acquisitions may be significant. If you have limited free cash, this will put the combined business under strain and therefore increase financial risk. It is critical that the funding structure allows breathing space for the inevitable integration challenges.

It is also key to ensure that the exiting owners are restricted in what they do post-transaction. Allowing them to set up a similar venture in close proximity could severely hinder your performance. Restrictive covenants need to be put in place to protect against this.

So, before taking the next step you should clarify why you think an acquisition strategy would be beneficial to you.

You should also analyse what strengths your company has which will make that particular strategy work and whether any inherent weaknesses may add to the risk of it going wrong.

The next thought process should consider yourself, your team and the current position of your existing company.

- Are there critical short-term challenges in your existing business which may make the timing wrong?
- Do you have a strong enough management team?
- Do you have a second-tier management team who can assist and take on additional responsibility?

These questions are important in the sense that during the acquisition and post-acquisition integration process your attention will be diverted from your current business for a substantial amount of time. You should be comfortable that this can be managed and will not harm your existing company.



Get an advisor on board

As with most major business decisions it is important to seek advice at the right time from the right people.

Bringing a Corporate Finance adviser on board early in the process will assist. Amongst other things, your adviser will:

- Test your strategy.
- Assist in gathering information and identifying targets.
- Approach targets confidentially.
- Assess valuation expectations.
- Negotiate a workable deal.
- Assist in arranging funding, advise on the right structure for the deal and negotiate the best terms with finance providers.
- Assist in due diligence.
- Project-manage and alleviate pressure on your team.
- Understand and take you through the entire process.

Advisors also offer objectivity to your transaction. By using an intermediary throughout negotiation stages it will mitigate any direct conflict between the two parties and assist in generating a positive relationship post-sale. It is important to remember that once the transaction has completed it is common for the seller to remain in the business for a length of time to assist in the hand over.

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The process:

1 Finding target businesses

In our experience, target businesses have often emerged naturally. Approaches may have been made to your company, alternatively, word of mouth in your industry or commercial dealings have identified an opportunity with a partner.

However, your advisor will generally have access to company databases and professional networks which will assist in locating target businesses for you if you are starting from scratch. In order for them to assist effectively they will need to know what your key requirements are. For example, they need to know your reasons and strategy for the acquisition, size of business, sector, location etc.

Most companies are for sale, given the right offer and timing; therefore you should not narrow your scope down to just those that you see marketed.

You should research your targets as thoroughly as possible. Invest time in this stage to ensure your short-list is as close to your initial criteria as possible.

2 Preliminary dialogue

Your advisor will be able to front your approaches in order for you to remain anonymous at this stage, if this is appropriate. This is especially important if you are targeting businesses that are in your sector, or suppliers/customers, as it may impair future relations with these parties. Bear in mind that at some point however you will need to disclose your identity.

If the target is willing to hold preliminary discussions use the opportunity to tee up a meeting; information is passed over more freely and efficiently whilst face to face. Gather basic information in an attempt to support or disprove your theory as to why the target is a good fit. You will then be able to make an informed decision on whom to progress talks with, and hence refine your target list.

3 Initial offer

You are likely, at an early stage, to be required to make an initial offer to the target in order for them to ascertain whether they wish to proceed. Your advisor will assist you in valuing the business on the information you have obtained so far.

There are many different ways to value a company, largely depending on what sector it is in and its profitability. However, you need to consider the benefits you will gain from acquiring the business and whether this justifies the cost. In addition, you should look to recover the purchase price and repay related finance in roughly 4-5 years.

At this stage, you should start to seek financial backing if you have insufficient funds to cover the deal. Ensure you have a comprehensive business plan which supports your case and justifies your reasons for the proposed acquisition.

“ Research your targets as thoroughly as possible. ”



4 Cementing the deal

Your advisor will have relationships with a number of funders already; it will be easier to allow your advisor to approach their contacts, as they will be more receptive to your advisor than if you were to approach them independently. You should discuss your plans with your current bank as they will already know your history, but again only after a fully-developed business plan has been prepared.

The business plan is a key document which it is critical to get right to give you the best chance of obtaining funding. Your advisor will have handled this process many times over and instinctively understand the best way to present your case and the funding sources that may be interested.

If your offer has been initially accepted you should seek to gain exclusivity on the deal at this stage. There may well be a number of different parties interested in the same business, especially if it is being marketed for sale. Exclusivity will provide a certain period of time to complete the deal, without the risk of the target company being acquired by another party.

Unless you have a close link to the target business already, let your advisor lead the negotiations on your behalf. However, you should approach negotiations with the aim of reaching a mutually beneficial solution for both parties.

You should establish in advance the key areas that are imperative or critical to the deal, your target price and range for negotiation and also supportable rationale for that price or structure.

Also, remember at this stage the emotional aspects. The vendor may not be committed to selling, or they may have emotional ties to their staff, customers or suppliers which come into play. It is critical that this stage is handled sensitively and with understanding, as personality clashes can destroy good deals just as building good relationships can cement the way forward. Honesty, integrity and openness are critical to positive negotiations at this stage.

Once you have reached a stage of agreement on most aspects of the deal you will be able to draw up a document known as the 'Heads of Agreement' or 'Heads of Terms'.

The Heads of Agreement will summarise all main aspects of the acquisition deal, typically being price, future involvement of the vendors (if any), terms for payment of the consideration, any earn-out elements (price based on future performance) and the main assumptions made.

Although not legally binding (other than in respect of confidentiality and exclusivity), the heads of agreement carry a moral obligation on both sides to stick to the deal unless something material, and at that time unknown, comes up during the remainder of the process.



The process (continued):

5 Structuring the deal

The major aspect of the deal that vendors and buyers concentrate on is the price, and how and when it will be paid. However, there are far greater issues that may be just as crucial to the deal, that your advisor will be looking at as well.

The structure of the transaction and the ability to fund the acquisition cost will be their main priority. There are typically two methods of buying a company, a share purchase or trade and assets purchase.

Share purchase – this involves the shares of a company being acquired. Thereby you own the physical entity of the company and as a result you acquire the full balance sheet as it is stated in the accounts. In this case, you will be buying the history of the company, which includes any hidden liabilities that are not covered by warranties or indemnities during the legal process of the acquisition.

Trade & assets purchase – in this case you will buy some or all of the assets of the company i.e. the business and its underlying assets. The shell, the company, would remain with its previous owners as, typically, would all hidden liabilities. In this instance however it is critical to define exactly what you are buying as there may be areas such as intellectual property which are a hidden asset but critical to the business.

There are a number of reasons for adopting either structure, generally driven by tax considerations and attitude towards risk. Again, your advisor will be able to take you through the pros and cons of each method.

In either case current UK legislation (TUPE Regulations) requires employees of the target company to be taken over on current employment terms and there are very few exceptions to this.

In addition to advising on suitable sources of finance, there must be a fundable structure and proposals need to be made as to what form the consideration will take. There are a number of options available, most commonly:

- **Cash**

This is the easiest and most sought after option for a vendor, as they can bank it on day 1 and it therefore carries no ongoing risk (or reward). However, the buyer may not have the capacity to pay the full amount up front, nor would want to as it is a high-risk approach and leaves recourse only via alternative legal protection in the documents.



- **Shares**

It is possible for shares in the target's company to be exchanged for shares in the buyer's company. This will not provide cash up front but the vendor may be entitled to annual dividends and can potentially gain further if they dispose of the shares at a later date. This option will be more popular if your shares can be easily traded and therefore provide a ready exit route. Shares are typically therefore only acceptable to a vendor if your company is quoted. However, there are instances where the vendors will continue to be employed by the enlarged group and a shareholding provides an ongoing incentive to create further value.

- **Deferred consideration, usually in the form of loan notes**

This option eases the buyer's cashflow as it allows payment to be made over an agreed timeframe, effectively a loan between vendor and buyer. There are many different aspects of loan notes to consider including interest, security etc.

The methods of payment shown above can be used in varying combinations, as well performance-related consideration in the form of earn-outs.

“ The major aspect of the deal that vendors and buyers concentrate on is the price... ”



The process (continued):

6 Investigating the target company

A detailed due diligence process is not an option but a necessity. You are making an investment that may significantly affect your future business as well as your personal reputation. It is important that the vendor appreciates the extent of your expectations in this regard, from the outset. Discussion and input by those funding the acquisition is also important before the due diligence process commences. Due diligence investigations can broadly be split into the following areas:

- Commercial/market
- Financial
- Legal

We would generally recommend that your professional advisors are involved in the financial and legal areas. Depending on your in-house expertise, external advisors can also be employed to provide valuable commercial or market insights that may affect your views on the business and the price. However, in-depth investigations by your own team on the company's operations, the commercial aspects of the corporation, including people integration and the market generally are crucial to most successful acquisitions.

Whilst there is no prescriptive degree of detail attached to the investigation process, it should enable you to feel comfortable with all key aspects of the target's business, both historically and in the short-term future.

This process normally takes weeks rather than days and involves as much access to the vendor's business as can be agreed, whilst maintaining confidentiality. In particularly sensitive acquisitions the use of advisors can help the purchaser gain comfort from investigations whilst maintaining confidentiality for the vendor of key commercial areas, such as the identity of customers, until a late stage.

Providing no "deal-stopping" issues are unearthed through this process, the investigations provide the basis for the following:

- Renegotiations of price if significant issues affecting your valuation of the business come to light.
- Appropriate legal protection to be incorporated in the Sale and Purchase contract to cover issues raised.
- Better appreciation of the overall financial commitment required to buy and run the business. This will enable a more informed view to be taken of the financing required.



“The challenges ahead are often significant...”



7 Steps to completion and beyond

Once the various due diligence procedures are complete and the price and final structure are finally agreed, the period to completion is likely to take at least a month. During this time all the necessary legal, and where appropriate, financing documentation will be put in place. For you, as the acquirer, this will be another busy period. In conjunction with your advisors, you will need to address the following issues:

- Understanding all tax issues and structuring the transaction in the most tax-effective manner for the purchaser and, as far as possible, the vendor. This may involve determining or negotiating with the vendor the form of the consideration and the timing of payments, as discussed above.
- Whether the vendor's tax status (either personal or corporate) creates any potential tax liabilities for the purchaser and how these can be eliminated or mitigated.
- The extent of the legal protection required to cover issues raised, whether these risks can be covered by indemnities given by the purchaser and whether any consideration should be held back in escrow for matters pending resolution or clarification.
- Handling the publicity of the deal to maximise any opportunities created by the acquisition or to minimise any adverse impact on either business.
- Securing the support of all employees, particularly those in the new business, ensuring terms are agreed and the risk of loss of key employees mitigated.

Completion is not only the culmination of a successful transaction but also the start of a new phase in the enlarged business. The challenges ahead are often significant, cultures are different, new strengths and weaknesses come to light and re-appraisals of the newly-enlarged operation need to be undertaken quickly and efficiently.

A well-managed acquisition process should therefore not stop at completion but have an active plan and strategy for the integration and management of the target business following completion.

Whilst challenging, acquisitions can provide great opportunities for growth and taking your existing company to a new level but managing the process in the right manner throughout is critical to getting the best deal.

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