FOUR
How to groom your company for sale

Houses need grooming for sale in order to obtain the best price, and so do companies.

When selling a home, a modest amount spent on redecoration and minor repairs makes it look more attractive and cared for. When selling a company, the grooming must be much more than a few superficial cosmetic improvements in order to get the best possible deal.

Whilst some vendors decide to exit and quickly achieve an outstanding deal, most companies can be made more saleable and achieve a substantially better price by careful grooming which may take from three months up to a couple of years, or even longer in exceptional circumstances.

The preparatory work involved in selling a company can be categorised as follows:

- Essential preliminaries
- Optional preliminaries
- Deciding what to sell
- Good housekeeping
- Separating out a subsidiary or division
- Enhancing value for the shareholders

Each of these categories will be described in detail.

Essential preliminaries

Circumstances which are likely to dissuade prospective purchasers from buying the company or will cause inevitable delay need to be resolved before it is offered for sale. It is naive to think that a purchaser will not discover them during the 'due diligence' investigation work prior to legal completion. Worse still, by then significant cost will have been incurred and the staff may be unsettled by rumours that the company is being sold.

Potential barriers to a sale include:

- litigation;
- warranty claims;
- problems with the tax authorities;
- planning uncertainties affecting land and property; and
- compliance requirements of regulatory bodies.

In general, the likelihood, threat or even possibility of one of these situations arising, and the consequent uncertainty, is more off-putting to a prospective purchaser than if the full extent of the problem is known.

Each of these potential barriers will be considered in turn.

Litigation

Probably the majority of companies are involved in or faced with the possibility of some kind of routine litigation at any time. Examples include the pursuit of monies owed to or by the company, and perhaps an unfair dismissal case. These are unlikely to prove to be a barrier to the sale of the business.

Litigation which could be commercially damaging or expensive to resolve may well prove a hazard. One actual case involved a building products company which had recently entered the US market. An American company claimed that the company's major product infringed their patents and that they would take vigorous action to stop further sales in the USA. A dispute of this kind may take years to resolve and may well render the company temporarily unsaleable.

Warranty claims

If a new product has been launched on a large scale and serious design or manufacturing faults have been discovered, then there could be substantial warranty claims to be faced in the months ahead. Fortunately, in such a case, it should be possible to estimate fairly accurately the anticipated warranty costs in excess of the standard provisions included in the accounts, and to demonstrate that the fault has already been eliminated in subsequent production.

Tax problems

An investigation in progress by the tax authorities, or the threat of one arising in the light of preliminary enquiries, understandably unsettles a prospective purchaser. It is far too glib to assume that because the vendors will be required to give comprehensive indemnities concerning taxation, the problem need not concern prospective acquirers. Purchasers are well aware of the professional cost and management time involved in handling a tax investigation, and are likely to be concerned that other problems may be raised.

Issues which may cause serious tax problems include such mundane matters as benefits in kind for directors and senior staff, and the payment of people on a self-employed basis when they should have been treated as employees.

The only possible advice to anyone envisaging selling a company at any time in the future is to handle all the tax affairs impeccably from the outset.

Planning uncertainties

Planning uncertainties affecting land and buildings can be either negative or positive, but both may affect the sale. A negative uncertainty concerned a freehold building on the outskirts of a major city which had a 'trade counter' and parking for customers along the front. As part of the 'due diligence' investigation work, it was discovered that the planning authorities had prepared a provisional scheme for a motorway spur road to be built which would lead to the loss of the 'trade counter' and parking facilities. Even though it was only a provisional scheme, and other alternatives were being considered by the authorities, the purchaser withdrew from the deal because of the uncertainty involved.

A positive uncertainty concerned the possible opportunity to redevelop a large site, and to relocate the business locally without the loss of key staff. The vendors offered written evidence that planning permission would eventually be obtainable and gave examples of the prices obtained for similar residential development sites in the city. Not surprisingly, prospective purchasers were not prepared to pay a price for the business which reflected the redevelopment potential value. The vendors were faced with relocating the business first, in order to eliminate the uncertainty to a prospective purchaser, extracting the original site from the company and selling it for redevelopment at a later date.

Compliance requirements

European Union legislation has affected many companies. For example, some food production companies have needed to invest substantial capital expenditure to upgrade their manufacturing premises and equipment or to change their product specification. Prospective purchasers will want to be satisfied that forthcoming or anticipated legislation requirements are being addressed, and that the requisite capital expenditure and impact on production costs has been included in budgets and medium-term forecasts.

Recent major financial scandals have lead to a tougher and more costly regulatory framework, and some pensions and investment providers face the threat of claims for miss-selling which may take years to resolve and are difficult to quantify in the meantime.

Optional preliminaries

There are two main option preliminaries, namely:

- vendor due diligence; and
- public relations (PR).

In many cases, the pros are far outweighed by the cons and so each will be considered in turn.

Vendor due diligence

For most disposal deals worth less than £50 million, vendor due diligence is a waste of money, consumes the vendors' precious management time and delays the sale process. Despite this, the corporate finance departments of major accountancy firms sometimes push this service as a means of maximising their fees.

A vendor due diligence report is usually carried out by a specialist team of a major accountancy firm. The aim is to give prospective purchasers a comprehensive picture of the business. If material issues of a legal, environmental or pensions nature are involved, other experts may need to be involved.

Vendor due diligence is carried out before marketing the company to prospective purchasers and it is likely to be at least three months before a purchaser signs Heads of Agreement, and wishes to carry out their own due diligence. Purchasers tend to be sceptical about vendor due diligence, and profit forecasts will be somewhat dated, and so it will not speed up legal completion.

When a company is to be sold by a publicly announced control auction, vendor due diligence is often appropriate. Quite rightly, private companies reject announcing a sale and are keen to maintain confidentiality as long as possible. Controlled auctions are appropriate for corporate subsidiary disposals, however, usually valued in excess of £50 million where the group is confident of achieving a sale at an acceptable price.

Public Relations (PR)

Many private companies make no effort to gain media coverage in either the trade or national press, on the grounds that it costs advisory fees and management time for little benefit. Some private companies use PR advisers, however, to generate additional profit and regard media coverage as a profitable investment.

Sometimes, an adviser will recommend seeking relevant press exposure 12 months before initiating a sale in order to raise the company profile. New product or service launches, major contracts won, successful customer project completions, awards won and senior executive appointments are likely to gain coverage. It is not a clear cut decision, however, and the cost and management time involved needs to be weighed against the expected benefits.

What to sell

Matters which need to be considered, and resolved where appropriate, include:

- Directors' other interests
- The ownership of property used by the business
- Overseas companies, including dormant ones

Each of these will be considered in turn.

Directors' other interests

A purchaser will need to be satisfied that there will be no conflict of interest after the sale. For example, the directors may be shareholders in a related business, which could compete to some extent with the business to be sold or create confusion amongst customers if a similar trading name is involved. Alternatively, a director may own and have a part-time role in a quite different business. If the purchaser requires the full-time executive involvement of the director in the business to be sold, then this potential conflict will have to be resolved.

In deciding what to include in the sale, the rule must be to avoid any possible conflict of interest after the disposal.

Ownership of property

In private companies, it is not unusual for properties used by the business to be owned by the shareholders as individuals, as part of their tax planning. As the company and the property are owned by the same individuals, it is quite normal that neither formal lease nor rental agreement exists for the use of the property by the business. An open mind should be kept whether or not to include the sale of the property with the business.

For example, if the value of the property is likely to increase substantially because planning permission may become possible for housing or retail development, then it may make sense to offer only a medium-term lease to the purchaser of the business.

Purchasers tend to become nervous when overseas property is involved. They will want satisfactory evidence that the title is owned by the company. If this cannot be established, then it could affect the sale of the business. It must make sense whenever buying property overseas to ensure that the legal work is handled professionally and that adequate evidence of title is available.

Overseas companies

Some companies register overseas subsidiaries in order to protect the use of the company name. Perhaps some of the subsidiaries do not actually trade. It may seem attractive to a vendor not to sell one of these because it may provide an opportunity to establish overseas residency for tax purposes and to have a continuing business interest as well. It must be recognised, however, that a prospective purchaser will wish to avoid any conflict or the inability to use a valuable trading name in another country.

Good housekeeping

The lack of good housekeeping is unlikely to present a barrier to the sale of a company, but it may cause some delay. The existence of it, however, is an indication of professional management and is likely to be reassuring to a purchaser.

The elements of good housekeeping include:

- Shareholder agreement to sell
- Share structure
- Taxation affairs
- Accounting policies
- Employment contracts
- Incentive schemes
- Intellectual property

Each of these will be considered in turn.

Shareholder agreement to sell

A purchaser will usually wish to be satisfied that 100 per cent of the equity is available to purchase. Alternatively, if only a tranche of the equity is to be purchased initially, the purchaser may insist on an option to purchase the remainder. So it is essential to obtain the agreement of all the shareholders to sell their shares. If some of the shares are owned by a financial institution they may only agree provided that a given price is obtained, and one which may not be at all easy to achieve. If some of the equity is held in a trust, then extra time may be needed to obtain the requisite agreement to sell, especially if it is based in an offshore tax haven. If one of the shareholders has died without leaving a will, or probate of a will has not been granted, this may cause delay.

It is a necessary preliminary step to obtain the agreement of all the shareholders to the sale of the company.

Share structure

The best share structure to have for the sale of a company is simply one class of ordinary shares. Whenever there are different classes of ordinary shares, with different rights attached, there is a risk of disagreement. The different classes of shareholders are likely to have conflicting views concerning the relative values of each class.

So it is desirable to reach agreement about relative values before the company is offered for sale, and anything which is done to simplify the share structure helps to avoid disagreements at the negotiation stage.

Taxation affairs

Purchasers are reassured when all the taxation affairs of the company are up-to-date, in correct order, and the approval of the tax authorities has been obtained for computations submitted.

This applies to all tax affairs including:

- Corporation tax
- Capital gains tax
- Employee income tax
- Overseas profits and income
- Dividends received and paid
- Benefits in kind for directors and senior staff

There is merit in always ensuring that all tax affairs are kept up-to-date continuously, but perhaps this is a counsel of perfection. One thing is certain, however, as soon as a decision to sell the business has been taken then strenuous efforts should be made to bring the tax affairs up-to-date.

Accounting policies

It must be realised that as soon as the sale of a company is legally completed, a purchaser will install common accounting policies. Furthermore, it is completely naive to assume that a purchaser will be fooled by accounting policies which artificially inflate profits, for example the use of extended periods for the depreciation of fixed assets. Purchasers usually restate the profits of the target company using their own accounting policies as part of their valuation calculations. So there is no benefit to be gained by choosing accounting policies to artificially inflate profits.

Employment contracts

In many countries, legislation requires that each employee has a written contract of employment. Some private owned companies ignore this requirement but it should be complied with as part of their preparation for a sale of the company.

Incentive schemes

Some private companies have individual incentive schemes for directors and senior staff which may be totally unacceptable to a large purchaser. In an electronics company employing about one thousand people, the twelve most senior people had personal incentive schemes which they had negotiated individually with the principal shareholder and chairperson. Furthermore, the schemes were open-ended and ill thought-out. For example, the group marketing director received a bonus calculated as a fraction of one per cent of total sales, payable even if the company made a loss. Also, no provision had been made to exclude sales resulting from the acquisition of another company. The purchaser insisted that these incentive schemes were 'bought out' prior to legal completion.

Intellectual property

The administration of intellectual property such as patents should be in order and up to date. Patent renewal deadlines should have been met so that adequate patent protection exists. Wherever appropriate, patents should have been applied for in the overseas countries where trading takes place.

Separating out a subsidiary or division

Several months may be needed to arrange the affairs of a subsidiary or division so that it can be separated out easily and cleanly.

The issues which need to be addressed include:

- Premises
- Use of central services
- Pension entitlement
- Use of intellectual property

Each of these will be described in turn.

Premises

There may be various situations which need action. The premises may be owned by a property subsidiary of the group and leased to the business to be sold. A decision must be made whether or not to sell the premises, taking into account the potential increase in value in the foreseeable future and the crystallisation of any capital gains tax liabilities by selling now. Another possibility is that the business to be sold shares the premises with another subsidiary which is to be retained. The use of the space may make it extremely difficult to separate the two businesses effectively. It may be preferable to offer the business for sale on condition that it is relocated within, say, twelve months, but some purchasers could find this unattractive or even unacceptable.

Use of central services

Some central services can be transferred more quickly and easily than others when a subsidiary or division is sold. Routine matters such as payroll preparation and pension administration fall into the 'easy' category. A dependence on an integrated information systems technology capacity may well be difficult to transfer quickly, especially if the software used by the purchaser proves to be incompatible.

It is unrealistic to think that the information technology issues can be resulted until a particular purchaser is in sight. The preparation which should be done before then, however, is consideration of a reasonable handover period and a basis of charges for services provided in the meantime.

Pension entitlement

The pension fund assets and liabilities relating to those staff who are to be transferred on the sale of the business need to be calculated by a firm of actuaries, or by an insurance company if they manage the group scheme. This is likely to take quite a while and instructions should be given sufficiently early to ensure that legal completion is not delayed.

Use of intellectual property

There may be certain patents, brand names, copyright and other intellectual property owned by the group, which will need to be transferred. This should be relatively routine but a complication may arise if the intellectual property is also used for the benefit of other subsidiaries which are to be retained by the group. Some form of licence will need to be drawn up.

Enhancing shareholder value

The most important preparation work to be done is that designed to increase the financial benefit to the shareholders.

Amongst the aspects of the business requiring adequate preparation prior to disposal are:

- Full asset valuation
- Full profit declaration
- Evidence of rising sales and profits
- A business plan
- Cost reduction and deferral

- Undue customer dependence
- Management continuity and key staff retention
- Surplus or unwanted assets
- Surplus cash
- Overseas expansion and diversification
- Acquisitions
- Effective management information
- Directors' pensions
- Future salaries for directors

Full asset valuation

Properties may not have been valued for several years and be undervalued on the balance sheet. Whilst purchasers will usually base their valuation of the business on profits and cash flows, you should point out the current market value of any property because this effectively reduces the goodwill or premium over the net asset value for the purchaser.

Formal property valuations are expensive and not necessary for this purpose. You should simply seek to get a current value by researching local commercial property valuations or obtain an informal opinion from a friendly property surveyor.

Full profit declaration

Stock and work-in progress may be valued conservatively by private companies in order to minimise the corporation tax payable. One method is to provide generous stock provisions in the accounts. This has particular significance for the value to be obtained by shareholders, because an important determinant of the price to be paid for a business is the profit after tax of the business.

A simplified example will illustrate the significance. Assume that the stock and work-in progress are undervalued on the balance sheet at the time of sale by, say, £300,000. If this is merely pointed out to the purchaser it will have little or no impact on the price offered. The benefit is likely to be treated merely as increasing the net asset backing as a percentage of the purchase price.

Now consider if the £300,000 were to be released into the profit and loss account during the previous financial year, the current year and the next one. This would increase the annual pre-tax profit by £100,000. If the corporation tax rate is 30 percent, the increase in profit after tax will be £70,000. If the purchase price were calculated on, say, ten times post-tax profit, this would increase the value of the business by £700,000.

The message is clear. Do not understate profits in the lead-up to a sale of a business.

Evidence of rising sales and profits

The natural concern of any purchaser is the risk of buying a business which has reached a plateau, or worse still, is about to decline.

The desirable pattern to demonstrate is:

- Sustained sales and profit growth during the previous three years.
- A further improvement for the current financial year.
- Evidence of another increase during the following year as a result of business development already in the pipeline, such as new products, branch openings or overseas expansion.
- Profit margins being maintained or improved.

So it is important to demonstrate rising sales and profitability of the business in the two or three years prior to the sale.

Business plan

When a group is disposing of a business, prospective purchasers will be keen to read the current business plan. Whilst projected sales and profit forecasts may be viewed with considerable scepticism, the narrative describing opportunities and business development projects to be pursued will be read with considerable interest.

Relatively few privately owned companies take the trouble to produce a written business plan for the next three years. If one exists, however, it will be looked on favourably by prospective purchasers. If not, the vendors and their professional advisers must adequately describe and sell the business development opportunities to prospective purchasers.

Cost reduction and deferral

Many purchasers value a business as a multiple of annual profits, so the profit for the previous and current financial years are vitally important. In the case of an earn-out, the forecast profits for the two following years will materially affect the structure and amount of deferred purchase consideration payments.

Wherever possible, indulgent expenses should be deferred such as:

- redecorating premises;
- re-carpeting offices; and
- refurbishing the car park and such like.

Equally, discretionary expense should be reviewed and reduced wherever possible, without damaging the performance of the business such as:

- advertising;
- corporate hospitality; and
- medium or long term research and development projects which will only benefit the new owners.

Surplus or under-performing staff should be removed humanely and generously, otherwise the purchaser is likely to do so and may treat people less generously.

Undue customer dependence

One customer or client may account for more than 50% of the total gross profit of a successful company. The loss of the customer, or even dual sourcing with another supplier, would plunge the business into losses. Some purchasers would find the degree of vulnerability too great, and others would insist on an earn-out linked to key customer retention. If the customer is acquired by another company, supplier rationalisation often happens and the account could be lost even though service performance has been satisfactory.

At least two years before initiating a sale, every effort must be made to reduce the dependence by winning other major accounts or diversifying into an adjacent market segment.

Management continuity and key staff reduction

Unless the business is loss-making or is to be absorbed into another subsidiary of the acquiring group, the purchaser will want an established managing director to continue. Appointing yourself as chair person and promoting someone to general manager or managing director shortly before sale will fool no one. You need to demonstrate that you have stepped back for at least a year and handed over key roles, such as business winning, successfully. Better still, you may have already reduced your involvement to part-time.

The loss of your managing director or a key team of software designers shortly before initiating a sale may cause you to delay a sale or will reduce the realisable value. Even if your key people are well paid, there is always the risk that someone will offer more. Share options may persuade people not to be tempted, but it is important that people cannot cash in their options on leaving because this could incentivise them to go rather than to stay.

Surplus or unwanted assets

Surplus assets, such as equipment and surplus or redundant stock should be sold, or scrapped if necessary. Cash flow is improved, more space for expansion by the new owners is created, and a better visual impression of good housekeeping is created as well.

Surplus cash

A cash generative business is attractive to purchasers, but it is not necessary to leave surplus cash on the balance sheet. At the outset, tell prospective purchasers that either the business will be sold on a cash and debt free basis or only with sufficient cash for current year working capital needs. If you only mention this later, the purchaser is likely to say that their valuation assumed the cash would be left in the business and so they need to reduce their offer by the amount of cash to be taken out.

Overseas expansion and diversification

Diversification or overseas expansion are likely to incur losses for at least a year and provide a management distraction as well, which will reduce the value of the business to a purchaser. Some vendors naively believe that the future prospects will encourage a purchaser to pay handsomely for them, but until profitability has been demonstrated this is improbable.

Acquisitions

Shrewd acquisitions can enhance realisable value but timing is important. Purchasers are acutely aware acquisitions often perform less well than expected and this may not become apparent during the first twelve months. If an acquisition is material, then ideally the performance should have been proved during a complete financial year before initiating a sale of the enlarged business.

Future salaries for directors

If an earn-out deal is involved, the directors will be keen to keep their salaries low where there is a benefit to be gained under the agreed formula. For example, if the earn-out payments are to be five times the profit before tax over a target figure in the current and following finance year, the lower the directors salaries are set the more they stand to gain from the earn-out payment.

If an outright sale takes place, however, then it is in the directors interests to negotiate the best possible reward package if they are required to enter into a service contract to manage the business for a period for the new owners. It may be possible to negotiate a profit-related bonus in addition to the basic salary to be paid.

Effective management information

A well-managed business, either privately owned or part of a listed group, should have annual budgets, reliable monthly management accounts produced promptly, and current financial year forecasts of sales and profits updated regularly. Mere opinion of the likely sales and profits for the current financial year is likely to be viewed with scepticism.

The production of budgets, prompt monthly accounts and updated year-end forecasts is sound business. So it makes sense to introduce these well before a sale is intended.

Directors' pensions

In the two or three years prior to a sale, or at least during the year of sale, consideration should be given to the benefit for directors of the company making substantial lump-sum payments to a personal pension scheme, especially if the directors have not made adequate pension arrangements for themselves. From a purchase price standpoint, there should be no adverse impact because a purchaser should 'add back' the pension payments as these will not be a continuing cost.

Executive summary

Preparatory work falls into several categories:

- Some problems, or even potential problems, need to be resolved prior to sale. They include:
  - litigation
  - warranty claims
  - investigation by the tax authorities
  - compliance requirements of regulatory bodies
  - planning uncertainties affecting land and property
  - legislation affecting produce specification or production facilities
- What is to be sold needs to be decided, including:
  - directors' other interests
  - ownership of property used by the business
  - overseas subsidiaries
- Good housekeeping which needs to be done before selling includes:
  - all the shareholders agree to the sale
  - relative values of different classes of shares agreed
  - taxation affairs and computations agreed and up-to-date
- Separating out a subsidiary or division requires:
  - sale or lease of property to be decided
  - transfer of central services to be considered, especially information technology
  - calculation of pension fund assets and liabilities for staff to be transferred
  - transfer or use of intellectual property to be arranged

- Enhancing shareholder values should involve:
  - full asset valuation
  - full profit declaration
  - evidence of rising sales and profits
  - a concerted drive to maximise profits