THOROGOOD
PROFESSIONAL
INSIGHTS

Chapter 2
Realize a reality check is vital

Chapter 2
Realize a reality check is vital

Corporate vendors contemplating the sale of a subsidiary are just as likely to over-estimate the attractiveness and realizable value of the business, as is any owner of a private company. Countless times, I have seen people absolutely convinced that a particular strategic buyer will pay a top price, only to find that they are either not interested or make a disappointing offer. Any rose tinted view must be tempered by tangible evidence.

How strong are buyer appetites in your sector?

If you have not had a single unsolicited approach from a strategic buyer, even informally, during the past two years, this should cause you to question just how attractive your business really is. On the other hand, if you have received, say, three approaches in the last six months, this could be a clear signal that you should be considering a sale in the near future. Acquisition activity in a sector may be quite pronounced for a couple of years, only to be followed by inactivity as acquirers integrate the companies, having satisfied their appetite for the foreseeable future.

Test your opinions by beauty parading corporate finance advisers

Chapter 6 is devoted to choosing, appointing and managing professional advisers, but corporate finance advisers can provide a valuable reality check for you free of charge before you decide to initiate a sale.

Also they should be keen to meet you, say, two years before you intend to sell because they will have the opportunity to keep in touch with you in the meantime.

You should arrange the meetings about three weeks in advance, so that the advisers can prepare adequately, and tell them that the agenda should include:

- their opinion of how attractive your business is;

- a review of relevant acquisitions during the past two years to indicate buyer appetites;
- the name of likely buyers, and equally importantly anticipated non-buyers;
- the likely realizable value and anticipated deal structure;
- their deal experience in your sector; and
- the proposed advisory team members and fee structure.

A review of relevant acquisitions made in the sector will reveal which companies have been buying, the size of deals done and any particular type of business which seems to be attractive. Equally important, the corporate finance adviser's knowledge of the sector should provide a valuable insight into likely buyers and non-buyers. Also, the adviser's view of both the attractive and unattractive features of your business should provide an indication of some of the pre-sale grooming which needs to be done before initiating a sale. Chapter 4 is devoted to grooming your business in order to maximize saleability and value.

Be realistic about likely value and deal structure

The adjusted pre-tax profit for the previous financial year and the current year are key determinants of deal value, unless there are valuable freeholds owned by the company which would inevitably increase the deal value.

The adjusted pre-tax profit is a key figure for any vendor because it is the profit the new owners would benefit from at the outset. In the case of a subsidiary company, there may be allocated management charges to be added back. For a private company, there could be significant add-backs such as:

- the excess of salaries taken by the owners, compared to the level an acquirer would pay and the attendant employers national insurance costs;
- any excess personal pension contributions made by the owners, compared to the amount applicable for an employed executive in the same role;
- any salary savings as a result of an owner retiring on the sale of the business, where the person will either not need to be replaced or only at a lower salary cost; and
- any salaries and benefits received by family members as a non-executive director.

Quite often these owner add-backs may legitimately increase the profit by 50% or more, and in some cases at least double the profits.

Corporate finance advisers will be able to estimate the multiple of adjusted pre-tax profits which is likely to apply to your business, but the multiple chosen is subjective and truly a matter of opinion.

Typically, distribution and sub-contracting businesses attract the lowest multiple, often in the range of four to five times the adjusted pre-tax profits for the previous financial year. Consulting businesses are frequently valued at only a multiple of five or six, because there is the risk of staff leaving and setting up in competition.

Only a small proportion of businesses command a value of more than seven to nine times the adjusted pre-tax profits for the previous financial year. Sectors which have commanded the highest valuations include specialist information technology businesses, publishers and regional newspapers.

It must be recognized, however, that the actual amount paid at legal completion may be significantly less than the overall deal value for a private company. The acquirer may insist that some of the purchase consideration will not only be deferred but entirely contingent on the profit performance achieved in either one or two years post acquisition. If the vendors reject this type of deal, it is quite possible that a sale is effectively ruled out.

Obtain shareholder agreement at the outset

The majority shareholder cannot assume that other shareholders will agree on the timing of a sale and/or the lowest acceptable deal value and minimum payment at legal completion. Unless specifically provided for in a shareholders agreement, a sale can be blocked by the owners of 25% or more of the issued shares.

Actual examples illustrate potential difficulties graphically. The founder of a business was 62 and, as a prelude to selling the business, the three executive directors had been given share options equivalent in total to 15% of the share capital. The founder had gradually become part-time and largely non-executive in order to demonstrate to any purchaser that the other directors, aged around 40, had managed the business successfully for some time and provided adequate continuity without him.

Significant profit growth was expected throughout the medium-term, and the founder was shocked and wrong-footed by the reaction of the executive directors. They did not wish to see the business sold for at least three years in order to maximize the value of their share options and did not want to pursue a management buy-out as an alternative way for the owner to achieve an early sale. They hinted that they could, and might well, undermine an early sale, which was used successfully as a bargaining tool to gain them more share options for their support.

Private equity investors, still often referred to as venture capitalists, may have a big say in any sale. They may set a minimum acceptable deal value which effectively rules out a sale for the time being. If an earn-out deal structure is anticipated, a private equity investor may demand that they should receive full value at legal completion because the acquirer will only wish to incentivize continuing owner-directors. Some hard bargaining with the private equity investor may be needed, and it should be addressed in principle at an early stage of the sale process.

On the other hand, a private equity investor may be keen to sell earlier than the owner-directors, either because their investment fund is due to be closed quite soon and monies have to be returned to the fund investors, or because they wish to accept an unsolicited offer even though the management team may be keen to continue.