DMH Stallard

A brief guide to selling a business

Introduction

This guide is designed for business owners with specific recommendations to ensure a sound pre-sale and sales process based on our extensive legal experience of working on business deals.

A brief guide to selling a business

> “Early review of key value drivers will help maximise the value you realise.”

1. Choose advisors with care

Working with an experienced professional team, (lawyers, accountants and corporate financiers) will help the deal go more smoothly and could increase the ultimate exit value. We can help you decide if all of these advisors are needed and and who will be the best fit for you and your circumstances.

2. Why sell a business?

Deals can be planned over time, or may emerge from a direct approach from a broker or someone you know in the trade.

Whichever route, it is critical to understand the real value drivers, and any possible weaknesses in your business. You may have time to address weaknesses, and to increase value; key value drivers may affect when you go to market.

3. Is the business ready for sale?

The sales process will be challenging, with every aspect of your business critically analysed.

Early review of key value drivers will help maximise the value you realise.

You can focus on key value drivers or plan a fuller diligence process, so you are ready for a buyer’s approach. How you proceed will depend upon what your timetable is, and how certain you are of securing a deal.

We recommend an early business review, to identify the right approach for you and the key value drivers for your business.

> “Identify strengths and weaknesses, ensuring strengths can be added to.”

Business review

- **Management team / key people -** are your management team and / or key people in place, and can they be retained through a sale process?
- **Commercial audit -** to identify strengths and weaknesses, ensuring strengths can be added to and weaknesses addressed.

During the commercial audit we regularly encounter:

- The need to strengthen key roles, so owners can leave on sale.
- Insufficient commitment by key people to the business. This can sometimes be addressed through share options or remuneration.
- Over-reliance on a key customer or supplier, or a need to secure long term customer value (fixed contracts or demonstrate longevity or relationships).
- **Key asset valuation** – are assets under-valued or over-valued? Should assets be excluded from the sale process?
  Informal arrangements regarding occupation of property owned by a key shareholder can be addressed in the deal negotiation and may provide flexibility.
- **Contract review** - can customers terminate contracts following a change of ownership? This may not be fatal, but customer meetings will be needed immediately prior to sale, to reassure buyers.
- **Commercial property liabilities** - are there inherent dilapidation liabilities, not recognised on the balance sheet, and can these leases be assigned?

Financial review

Does the business have robust accounting and reporting systems in place and will they be capable of withstanding reasonable financial due diligence by a prospective purchaser? Significant levels of value are at risk in a sale process if the sellers and their advisors cannot readily access trustworthy and accurate financial information.

Keep in mind that a buyer may well wish to secure the assets of the business to support the funding of the sale transaction and the financing of the business going forward. Banks, other financial institutions and private equity all expect robust financial reporting. Making information available in a well-structured and professional manner cements trust and confidence and will help the buyer address its own business case and inform those supporting the transaction financially.

In particular:

- Accounting policies – review the business' practices. Ensure they are in line with the relevant financial best practices for your market sector and comply with applicable financial reporting standards.
- Forthcoming regulatory changes – adjust for any that may have an impact.
- Monthly management accounts – content, quality, and availability. Can these be produced within a sensible timeframe after the end of each month?
- Variances and irregularities – one-off non-recurring items may give a false impression.
- Anticipate questions – and have answers ready to explain the past. Where possible eliminate instances going forward.
- Working capital – buyers will expect to buy the business with normalised working capital (so it can continue to run without new finance).
- Excess cash – subject to normalised working capital, excess cash will generally be paid for as additional consideration (which may be a tax efficient way to extract it).
- A proven and realistic business plan which anticipates growth will boost a buyer's confidence and may increase value.

Legal audit

Various matters can be dealt with by carrying out regular legal audits which cover aspects including:

- Governance issues – can include shareholder rights, but also historic company records, which can be frustrating if they have to be resolved at deal time.
- Contractual obligations – are arrangements sufficiently documented?
- Disputes – is there a history of disputes? Are there any matters outstanding?
- Intellectual property rights (IP) – are there any, have they been adequately protected? The business may have more IP than you realise and even if not registered/registerable, can add value if properly presented.
- Business structure – are all the assets of the business to be part of the transaction? Is a pre-sale re-organisation necessary?
- Employees – are key employees sufficiently tied into the business with enforceable written employment contracts?

> "To find potential buyers, your corporate finance advisor will need to prepare an Information Memorandum."

4. Preparing an Information Memorandum

If you wish to market your business, to find potential buyers, your corporate finance advisor will need to prepare an Information Memorandum (IM).

The IM presents your business in its best light, and identifies growth opportunities, if investment is made.

The IM will include a description of the business, its past performance and plans for the future. It will include details of key assets and any liabilities alongside key financial and other information about the business.

The IM will be circulated to potential buyers once they have signed a confidentiality agreement.

Marketing the business

As the IM will be the basis of any formal offer received, and will be the subject of any subsequent due diligence process, it is important the information is both well-presented and accurate.

Once the IM is ready to go, your corporate finance advisor will set about generating interest in your business. Often this will involve circulating a one or two page teaser document which summarises the key information (on a no names basis) to identified potential buyers. Initial circulation will be to third parties identified as potential acquirers on the recommendation of the corporate finance advisor, influenced by the seller's knowledge of their sector and market position.

You should consider with your corporate finance advisor how you want to approach the market, selectively or broadly, recognising you need to protect your goodwill.

Once the potential acquirers are sufficiently interested and have signed a suitable confidentiality agreement, the full IM is released to give the would-be buyers more information and to allow them to confirm their interest and formulate their offer.

Confidentiality

Keeping the opportunity and any information produced and disseminated confidential will be a key requirement.

It is customary to require interested parties to agree formal confidentiality terms. Sometimes the terms may apply to all parties including the sellers, and the relevant terms will be proposed by the sellers' legal advisors working in collaboration with the corporate finance advisors and at the sellers' direction.

Businesses should not overly rely on formal confidentiality agreements, which are, in practice, only as effective as the conduct and standing of those giving the obligations.

Best practice is to manage the release of information, maintaining sensitive information to be disclosed on an anonymised basis and/or only at more advanced stages of the sale process once the buyer's intention is judged to be serious and committed.

Information which is particularly sensitive, for example details of key customer and supplier terms and any confidential intellectual property such as proprietary know-how, may be so sensitive that its release needs to be carefully managed in the process.

5. Identifying a buyer

If successful, the outcome of the marketing process will be one or more serious expressions of interest.

The corporate finance advisor will assess the strength and relative merits of any interest received and will make recommendations about who should be taken forward as the preferred prospective purchaser. As the seller, you may invite or encourage the business' management team to put together a proposal.

The character of the prospective buyer will be an important element in your decision as to who to prefer. Interest may be from one or more of:

- Trade buyer – a competitor or new entrant to the market, likely to be a private or public company.
- Private equity – these types of buyers typically look to take a controlling stake in a business funded partly out of their own resources and also from debt. They do not take day-to-day control of the business but will look to incentivise the existing management team or an incoming management team with shares with the aim to grow the business rapidly over the next 3-5 years. Private equity commonly looks for significant projected returns on investment to justify their involvement.
- Management team – you may have managed the senior management team to be not only credible to an external buyer, but also to private equity and/or other funders sufficient to support a management buy out.
- Combination – often the interest of a trade buyer or management team will be supported by external funding or the involvement of private equity.

A well-advised seller will be looking at the marketplace for prospective buyers in the UK and often internationally - the more competition, the higher the potential price. Businesses wishing to enter the UK and/or to acquire a UK business to facilitate entry to regions in which the target already operates may produce interest and deliver a premium price.

Funding options

There are a number of ways a buyer can fund the transaction, the main sources being:

- **Debt** – simply borrowing from a third party, usually a bank, with set repayment dates over a period of time together with interest at an agreed rate. Security may be required over the assets of the target business.
- **Vendor finance** – in recent years there has been an increasing trend, particularly where the price offered for a business does not match seller expectations and/or where there is a funding gap, for vendor finance to support a sale transaction. Arrangements can include rollover shares in the buying company and/or secured and unsecured debt.
- **Existing cash reserves** – a private equity business and/or a trade buyer may have access to significant existing cash reserves and not require as much (if any) debt funding in order to complete the transaction.
- **Combination** – most transactions involve a combination of the above. In practice, most private equity backed transactions will involve equity and debt funding from a third party.

Heads of terms

Once one or a series of buyers have expressed interest in buying your business, you and your advisors will negotiate the headline commercial terms with a preferred bidder.

These are commonly referred to as ‘heads of terms’, ‘letter of intent’ or ‘offer letter’.

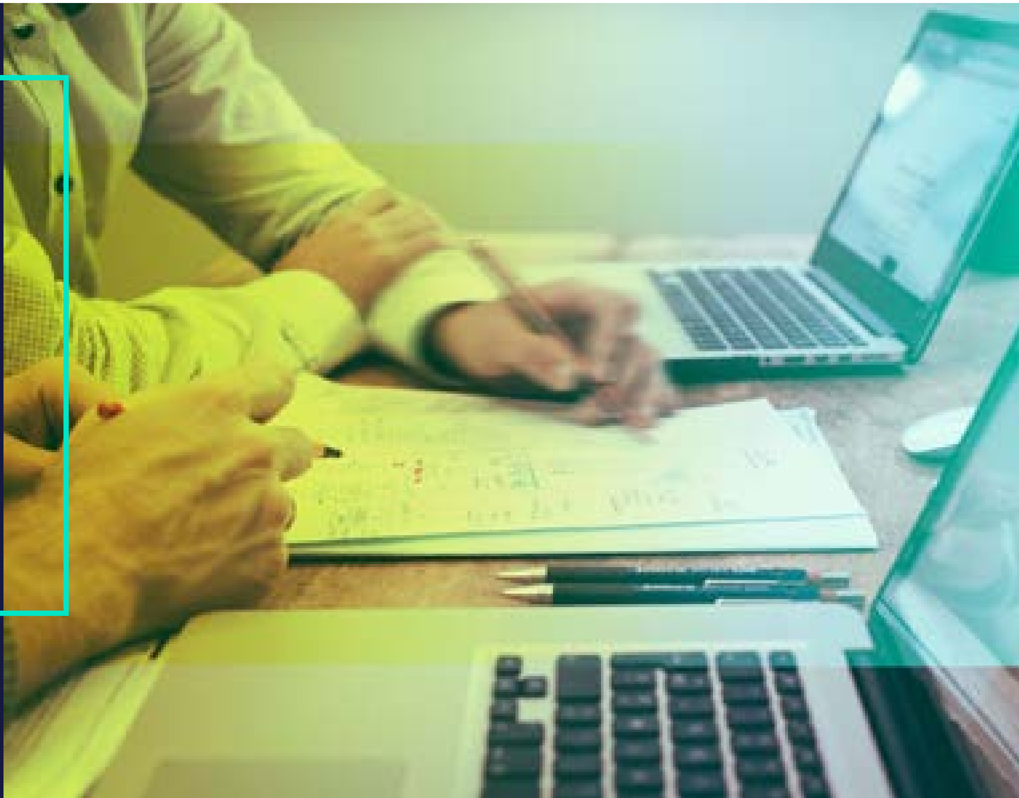
They are generally not contractually binding, save for provisions where the parties do commit, for example in relation to exclusivity, confidentiality and costs.

The main benefit of some formality before binding contracts, is to set in place confirmation of the key terms, any assumptions understood or accepted by the parties, and to establish a timeframe and process for the transaction. These will usually also address:

- **Transaction structure** – what is being bought? Is it the shares or the underlying assets of the business? Is anything being excluded, such as a property that the buyer does not want to take over after completion? These are important areas and often tax advantages may arise provided the transaction is structured in a manner best suited to the circumstances of the seller.

- **Payment terms** – how much are you being paid for your business and when? It is not uncommon for a portion of the purchase price to be paid on completion and for the balance to be withheld or paid on deferred terms over a period of time. It is becoming more usual for the purchase price to be linked to the future financial performance of the business, commonly referred to as an earn-out.
- **Special terms** – are there any pre-conditions before the sale or which the purchase price depends on, such as retaining a key customer or member/members of staff, renewing a key contract, approval of the buyer's board?
- **Exclusivity** – a buyer is likely to be committing a significant amount of resources to complete the transaction and so once a preferred bidder is chosen, they are likely to insist on a reasonable period of exclusivity.

"Once a preferred bidder is chosen, they are likely to insist on a reasonable period of exclusivity."



6. Due diligence

When buying a business, a buyer will want to be sure of what they are getting. A business is a complex entity that is constantly changing. In order to be satisfied that it is prepared to proceed with the purchase and so that it fully understands the business and what liabilities it is taking on, a buyer will usually undertake comprehensive investigations into your business, known as due diligence. Due diligence investigations will generally focus on three main areas:

- **Financial** – the buyer will usually instruct accountants to prepare a report on the financial standing of the business. This focuses on those areas of your business' financial affairs that are of material importance. Tax compliance will be a central part of the review and report.
- **Commercial** – addresses broader issues, such as the market in which the business operates, competitors, the business' strengths and weaknesses, production, sales and marketing and research and development. Some of the results of this part of the due diligence review may well be relevant to the legal investigation, for example intellectual property where ownership will be a legal issue. However, the technical performance of any know-how will more likely be subject to commercial assessment.
- **Legal** – expect this to largely focussed on the legal and compliance aspects of the business, for example: commercial contracts, employment, environmental and health and safety, intellectual property, freehold/leasehold property, IT systems, tax, litigation and regulatory and company constitutional matters.

Legal process

During or following the due diligence process, drafting and negotiating the legal documentation will begin. The main documents will include the sale contract and the disclosure letter. Depending on the type of transaction, there may be a raft of other documents supporting the sale contract, such as employment and/or consultancy agreements, finance documents, and agreements confirming any commercial arrangements not addressed in the sale contract, for example property leases if you own the business premises where pre-existing arrangements are to be replaced. Taking the main documents in turn:

- **Sale contract** – this document will set out all the terms under which you are selling the assets of your business or the shares in your business (as the case may be). Key terms, price, payment date, warranties, indemnities, limitations, availability and restrictive covenants will be some of the key areas for negotiation.

- **Disclosure letter** – under the sale contract, you will be required to stand behind a number of warranties you are giving relating to the business. A warranty is a contractually binding statement. If a warranty is not true, then you have the opportunity to inform the buyer of this in advance of completion and, therefore, the buyer's chances of bringing a successful claim against you after completion are significantly reduced. The disclosure letter is a formal document that your legal advisors will work with you to prepare and that sets out the reasons why a warranty statement is not true.

- **Tax deed/Covenant** – often included in the sale contract, but sometimes a separate document, the tax deed addresses the buyer's concern that the business is acquired on the basis that it has historically, up to completion, paid and accounted for the correct amount of tax due on the business' operations.

7. Completing the deal and post-completion

Completion

The two key elements that legally complete the transaction are the signing of the relevant documents and transferring the purchase price.

A mutually convenient date will be agreed between the parties, where the buyer, seller and their advisors will meet (usually at one of the solicitors' offices) to sign the documents or complete the deal remotely.

Post-completion

Inevitably, for the buyer, there will be much to do immediately before and especially after completion. Some of these matters will be managed through the contractual documentation where the seller has a vested interest. Examples include the manner and timing of announcements of the transaction to employees, customers and suppliers.

The buyer may want to integrate the acquired business with any pre-existing business they own and customer contracts may all be the subject of post-completion activity by the buyer, sometimes requiring the seller's support to ensure a smooth transition.

The price of the deal may be dependent on the balance sheet of the business on the day of completion and so the necessary accounts would need to be prepared and agreed. The contractual documentation will prescribe what is to take place post-completion in relation to any financial aspects of the transaction. Be prepared for a formal process and have the resolve to see through any disagreements that may arise.

To facilitate all that is required post-completion, you may agree to remain for a handover period or enter into a consultancy or employment arrangement for an extended period.

How we work with you

Client success

Our talented team listens so that we understand your needs; we bring empathy, expertise and creativity to help you meet your business goals.

Expertise

We engage and work with you to identify and prioritise your objectives using our knowledge and experience to deliver clear advice that works for you.

Relationships built on trust

We are committed to supporting our clients, our colleagues and the communities in which they work.

We provide exceptional legal services helping you to shape your future.

Our focus is you

If we can help you or your business please get in touch.

0333 323 1580
enquiries@dmhstallard.com

Visit our website →

Make an enquiry →

About DMH Stallard

In a rapidly changing world every business faces new challenges. Those challenges mean that there is an increasing need to be agile, and your legal partner must respond effectively and provide the right support for you. At DMH Stallard we know that our success is linked directly to helping you achieve your goals. We deliver successful outcomes for businesses.

DMH Stallard
Helping to shape your future

DMH Stallard