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A GUIDE TO BUYING A BUSINESS



CATTANEO
CORPORATE FINANCE

ABOUT CATTANEO

BACKGROUND

- An independent corporate finance lead advisory practice established in 2005
- Dedicated to providing outstanding service to clients in both public and private arenas
- Team comprises corporate finance professionals with experience gained across Private Equity, Investment Banking, Corporate Stockbroking and International Accounting Firms
- Based in Birmingham, United Kingdom, operating internationally
- Full range of corporate finance services
- Deal size from £0.5 million to £100+ million

WHAT WE DO

Cattaneo specialises in bespoke corporate finance advice and execution services for private and public companies, investors and management teams tailored to meet our clients' needs.

- | | |
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| • Cross border acquisitions and disposals | • Valuations |
| • Private equity | • Initial public offering (IPO) |
| • Debt finance | • UK Listing and AIM Rules |
| • Fundraising (including start-up, development capital and cash out) | • UK Takeover Code (including acting for overseas acquirers) |
| • Management buy-out (MBO) / Management buy-in (MBI) | • Pre IPO funding |
| • Business plans and financial models | • Takeover, both hostile and recommended including Rule 3 advice |
| | • Corporate governance |
| | • Strategic investment |



INTRODUCTION

This guide has been written for owners and managers of businesses who are contemplating buying another.

Acquiring a business is a common way to grow. However, many acquisitions do not realise the benefits that were anticipated and they can also have a detrimental impact on the existing business. So it is important to approach any acquisition process carefully in order to give yourself the best possible chance of getting it right.

This guide is designed for owners and managers who think they might like to take this route. We will cover:

- Why acquire?
- How to find a company to buy
- Approaching a target
- Assessing the target
- Valuation
- Structuring and making an offer
- Due diligence
- Post deal

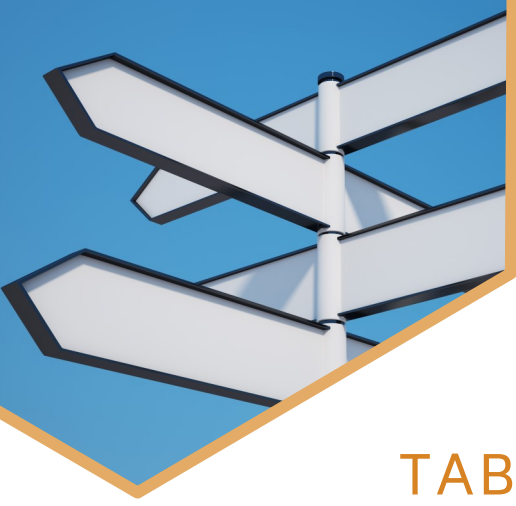


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WHY ACQUIRE A BUSINESS?

There are many good reasons for growing your business through acquisition and these include:

- **Diversification of the products, services and long-term prospects of your business.** A target business may be able to offer you complementary products or services which you can sell through your own distribution channels. This may save you the development time and cost.
- **Accessing a wider customer base and increasing your market share.** Your target business may have different distribution channels and systems which you can use for your existing products or services.
- **Reducing competition.** Buying up new intellectual property, products or services may be cheaper than developing these yourself.
- **Reducing your costs and overheads.** A shared overhead base (e.g. property, finance, marketing etc.) plus increased purchasing power can result in lower costs.
- **Obtaining quality staff or additional skills, knowledge and other business intelligence.** For instance, a business with good management and process systems may be useful to a buyer who wants to improve their own and an acquisition maybe easier than trying to recruit and develop your own.
- **Accessing valuable assets.** Better production or distribution facilities are often less expensive to buy than to build as they come with a ready made income stream. There is also the opportunity to achieve better utilisation from them.
- **Accelerated growth.** For example when the existing business growth needs to be accelerated. Businesses in the same sector or location can combine resources to reduce costs, eliminate duplicated facilities or departments and increase revenue. Additional turnover and profitability in chosen markets may mean that critical mass is achieved and this will make the new larger entity more attractive to potential purchasers.
- **Prevention of the target business being purchased by specific competitors.** Sometimes referred to as a defensive acquisition.



WHAT CAN GO WRONG?

The extent and quality of the planning and research you do before an acquisition will have a major impact on the chances of success. Sometimes situations outside your control will arise and you may find it useful to consider and prepare for these risks.

An acquisition could become expensive if you end up in a bidding war where other parties are equally determined to buy the target business.

An acquisition can damage your own business' performance because of the time spent on the deal rather than your own business and a mood of uncertainty if you are not clear about your objectives with your existing team.

You may also face pitfalls following a deal such as:

- The target business does not perform as well as expected;
- The costs you expected to save do not materialise;
- Incompatible business cultures;
- Key people leave;
- Resources (financial and management) are diverted from your business' main aims.



HOW TO FIND A COMPANY TO BUY

Having decided that you are keen to progress with an acquisition it is important to develop a profile of the sort of business that you want to acquire.

CRITERIA TO CONSIDER

- Size;
- Location;
- Compatibility of products or services;
- Routes to market and customer requirements;
- Management requirements;
- Technical knowhow.

Gather and review as much relevant information as you can on the attributes you are looking for. Once you have developed the target profile, you can:

- Consider businesses you sell to, or buy from, already. Many completed acquisitions in the UK occur between companies with some existing relationship (customers, suppliers or competitors). Vendors sometimes rule out potential buyers at an early stage, for a variety of reasons, and you should not rely on the grapevine to alert you to potential deals. On the contrary, you should use the close relationships that usually exist within sectors to your benefit by ensuring “the market” knows that you are a genuine and realistic potential purchaser.
- Encourage senior staff to use their networks to gather information about likely prospects.
- Use the business press to highlight opportunities either by allowing you to invite approaches by potential sellers, or by identifying companies for sale. This is an unsophisticated process, however, and the type of interested party it may give rise to should not therefore be a surprise! It can work, however, in a more focused manner, with trade press, specifically with in-fill acquisitions within a geographical area, for example.

- Circulate acquisition criteria to corporate finance houses and investment banks is a positive, but unfocused, attempt to learn of opportunities. Whilst deal flow may improve, you are likely to receive details of companies with only a passing semblance to your preferred profile, and you will not hear of them on an exclusive basis.
- Research suggests that more successful acquisitions are achieved when a purchaser has invested time and effort in a structured acquisition search exercise. Modern databases and information libraries make the research possibilities in the UK almost limitless, and it is possible for a potential acquirer to obtain a large amount of information on a vast number of interesting targets via on-line sources. The most challenging aspect of this work is to distil the information to such an extent as to make the project manageable and focused. Corporate finance advisers will assist companies with this research, and they should reduce the initial trawl down to a manageable number of companies who most accurately fit the acquisition criteria of the purchaser.

THE ACQUISITION PROCESS





APPROACHING A TARGET

When you have identified a suitable acquisition target you will need to register your interest in acquiring with the owners of that business.

There are three common ownership structures for unquoted companies in the UK: owner-managers; private equity / management team combination; and parent company (be it a public company or a larger private company).

The important issue is who to approach so that you get to the key decision-maker as soon as possible. A limited amount of research should allow the right person to be identified, whether it is the controlling shareholder, the private equity house or the group chief executive.

You may have reservations about making a cold approach to a target - a professional corporate finance adviser will have no such reservations and can add credibility to your approach by demonstrating that you are approaching this in a professional manner.

The "buffer" of an adviser between parties is a recurring theme throughout the acquisition process. There are no formal rules as to the most effective way to approach a target company. A letter followed up with a telephone call can be productive. The ability to interact with the decision maker and explain the rationale for the approach is an important part of the process. Again the most appropriate party to make that call is often the corporate finance adviser.

ASSESSING THE TARGET

Having established contact, and explained the rationale for your interest it is important to progress matters with some degree of efficiency.

The advantage of getting "ahead of the game" and being the only party in discussions can be significant. Most experienced corporate acquirers seek to avoid auctions, where prices can be forced up by the principle of supply and demand.

INFORMATION REQUEST

An initial information request should focus on those areas most relevant to valuation and compatibility with the acquisition strategy. The areas will include:

- Key drivers of the target's success;
- Target's products and services;
- Target's management and culture;
- Recent and future financial performance;
- Future prospects;
- Markets, customers and suppliers.

It will be important to compare the information received from the target, with that available from independent sources. This is particularly relevant for market conditions and future prospects, and will be revisited later.

VENDOR'S OBJECTIVES

You should attempt to work out the vendor's objectives, for example:

- Does the vendor have a motive to sell? If the answer is "yes" then understand why and what time pressures they are under.
- Does the vendor wish to sell the company or the assets of the company?
- Is money the prime motivation for selling?
- Does the existing management team intend to stay involved in the business?
- Are there any areas of the business which need to be changed?

At the outset, you will usually have to demonstrate your credibility as a buyer and it is likely that the target will require you to sign a "Confidentiality Letter" or "Non-disclosure Agreement". Since you are likely to divulge information about your own business as discussions evolve it is usually worthwhile to have this work in both directions. Typically certain highly sensitive information will not be shared until later stages of a deal, for example, customer names, margins by product etc. This information will become available once there is trust between the two parties and the likelihood of a deal increases.

You will want to ensure that the business has no major problems by conducting preliminary due diligence prior to making a firm offer for the business. If the vendor has prepared an Information Memorandum it may gloss over any weak areas.



VALUATION

To assess the value of the business you wish to acquire, you need to consider a number of factors such as reputation, competitive position, profit trends, cash generation and asset values, as well as external factors such as market position, sector rating, macro-economic conditions.

The value of a profitable business is most commonly determined by:

Sustainable earnings (profit) stream x Valuation Multiple

When using sustainable earnings before interest and tax, this calculation gives an "Enterprise Value". Deducting any debt from and adding any surplus cash to the Enterprise Value gives you the "Equity Value" of the shares in a company.

The factors referred to above typically influence the multiple, or range of multiples, that might be applied. Such multiples are often assessed by reference to transactions involving comparable companies and supported by looking at the company's relative position to businesses whose shares are listed on a recognised stock exchange. The former also provides a useful indication of the market appetite for transactions in the sector as well as an indication of potential buyers.

As well as deriving an appropriate multiple it is equally important to make an accurate assessment of the company's sustainable earnings. In the case of an owner-managed business in particular it is essential that profits are appropriately adjusted to reflect the earnings stream being acquired by a buyer. Adjustments may include such obvious items as non-market rate salaries and bonuses or personal expenditure but it is also necessary to assess less obvious areas such as unusual or one-off costs and revenues, customer gains or losses, new product launches, etc.

An alternative way of valuing a company is to discount its future cash flows at an appropriate discount rate in order to estimate its current worth. This method is most commonly used as an additional check.

At Cattaneo we understand that valuation is at the heart of everything we do and our detailed understanding of valuation methodologies, combined with our experience of buying and selling businesses across a wide range of sectors, enables us to provide you with a good (and realistic) indication of how much a business is worth.



STRUCTURING & MAKING AN OFFER

MAKING AN OFFER

In deriving your offer for a business you need to form a view on the future profits and cash flows of the business:

- **Make your own profit projections or at least test the assumptions behind those prepared by the vendor.**
- **Identify where savings can be made, and where there is scope to increase profits.**
- **Identify what you can "afford" to pay in terms of available funding.**

Consider your level of risk. Risk is higher if the target business:

- **Has minimal assets.**
- **Relies on one or two major customers (or contracts, or suppliers, or key employees).**
- **Is unprofitable, or has a chequered history.**

In making an offer you should consider covering the following areas:

- Your price.
- When the consideration is to be paid and in what form (cash, shares, loans etc).
- Your key assumptions both in terms of what you are expecting for the consideration and any assumptions you have made over profitability etc. Are you buying assets or shares?
- What further work you need to do and what approvals you need.
- Reasons why this offer should be attractive to the vendor (cash at completion, short handover period, retention of management, keeping the business as a separate entity, etc - i.e. make the offer sound attractive and highlight the softer issues that are likely to be important to the vendor).
- Next stages and timescales for a response.

HEADS OF AGREEMENT

If an offer can be agreed (often after much negotiation) then it is worthwhile setting it out in "Heads of Agreement". It is useful to get your adviser to draft these to ensure all key matters are covered. Experience says that thorough Heads of Agreement will make the rest of the transaction more straightforward as there is less room for misunderstandings. The Heads will typically cover a period of exclusivity as well to enable the transaction to be completed without the purchaser worrying about competing bidders.

NEGOTIATING A DEAL

Many business people have made long and successful careers from being good negotiators. It is surprising therefore, as to how poor those same people can be when negotiating their own transaction. It is an almost inevitable truth that a transaction in which you have a significant personal stake becomes a personal transaction. An adviser – whilst motivated to complete a successful transaction for his client – should be able to bring a degree of dispassion to negotiations that allows for clarity of thought and a level-headed approach.



DUE DILIGENCE & CONCLUDING THE DEAL

DUE DILIGENCE

Due diligence has become an increasingly important element of a transaction. Due diligence investigations can cover the following areas:

- Financial
- Commercial
- Technical / Operational
- Legal
- Taxation
- Environmental
- Pensions
- Insurance
- Management

Not every deal requires every aspect, and some elements can be carried out by the purchaser themselves while others might require specialist external advisers. If external finance is required then the funders are more likely to require more of the work to be carried out by external advisers to give them a third party view.

FUNDING

If a purchaser requires third party funding for a transaction (from a bank or private equity house) it is likely that a business plan will be required. This is a good discipline in any event, but it is overlooked surprisingly often.

It is imperative to begin the discussions with external funders at an early stage, particularly if those funders do not have an existing relationship with the purchaser or the target.

Funders, whether debt or equity providers, are by nature risk-averse, and they will not short-circuit procedures to meet deadlines imposed on them by transactions introduced to them at the eleventh hour.

The importance of project managing the fund-raising exercise alongside the acquisition itself cannot be overstated.

CONCLUDING THE DEAL

If issues arise from due diligence then it is important to consider how to use this in negotiating with the vendor. Be firm over the issues that have arisen and evaluate the impact they have on your previously agreed deal. Do you still want to progress? Does the price need adjusting? Does what you are buying need amending?

When you can see the finish line emotions will be running high so the assistance of your adviser should help maintain a level headed perspective on the transaction. If things aren't right, don't be afraid to walk away even if you have incurred costs.

WILL WE NEED TAX ADVICE?

Expert advice is needed before the acquisition is legally completed in order to ensure that the optimum structure is implemented and that the purchaser has the necessary protection in respect of any tax irregularities that may subsequently come to light. Issues that need to be addressed include:

- The structure of the transaction and the requirements for any tax clearances;
- Opportunities to minimise capital gains tax and inheritance tax liabilities on future gains;
- Tax indemnities from the vendor; and
- Payment of stamp duty.

DO WE NEED A CORPORATE ADVISER?

A corporate finance adviser should be appointed at the start and be fully involved in all aspects of the transaction until completion. The corporate finance adviser will work very closely with you throughout the whole rollercoaster ride. It is therefore vital to select an adviser you feel you can work with and who will provide the necessary experience and support when times get difficult – because they invariably will!

KEY AREAS OF INVOLVEMENT

- Finding and approaching targets;
- Assessing the feasibility of the acquisition;
- Advising on a valuation range for the target;
- Introducing appropriate funders (if required);
- Deciding on the nature of the approach and negotiating the best deal with the vendor;
- Negotiating the funding package (if required);
- Introducing other advisers such as legal and tax;
- Monitoring deal costs; and
- Project managing the transaction through to completion.



AFTER THE DEAL

Congratulations, the transaction is completed and you have acquired your target.

There is a lot to do over the next few weeks and months – as well as catching up on matters that have been deferred whilst you have been burning the midnight oil on getting to this stage. Many managers put together (as part of the business plan or separately) a “100 day plan” to cover the detailed aspects that need to be done.

Communicating to your (and your newly acquired company’s) staff, customers and suppliers is a key early task. It is important for you to communicate to all of the key groups your vision so as to carefully instil the necessary confidence in the new ownership. It is likely that you will need to give the some comfort about your future plans and the impact it will have on each key group.

It may also be necessary to install new independent systems for financial reporting, etc. if the target was previously part of a larger group. Even if the business was independent the systems may need to be strengthened to ensure that they provide necessary and timely information to you.

Finally positioning the business appropriately and planning for a fruitful exit cannot start soon enough.

Further information on this can be found in our “Guide to Exit Planning & Exit Strategy”.

WHY CATTANEO

You need an experienced corporate finance adviser with a proven record of advising on the acquisition and sale of businesses.

WHAT MAKES CATTANEO DIFFERENT?

- Our flexible approach that is client centric; we want to know and understand our clients' drivers and objectives and forge a close working relationship with them. Our advice is centred on helping clients to achieve their corporate and personal objectives.
- Our fees are weighted towards a contingent fee on success, designed to align our motivation with that of our clients.
- We have a dogged determination to provide solutions which make business sense.
- We offer value for money based on excellent experience and track record combined with a low overhead structure.
- Our team has direct experience in private equity, banking and industry.



For more information and / or a confidential discussion please contact us:

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