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A GUIDE TO

EXIT PLANNING & EXIT STRATEGY

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.

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

INTRODUCTION

This guide has been written for all owners of businesses – entrepreneurs who have spent their lives building successful owner managed businesses, management teams and their equity partners who have bought their own businesses with a view to selling them on for a capital gain, and corporate owners looking to divest subsidiaries.

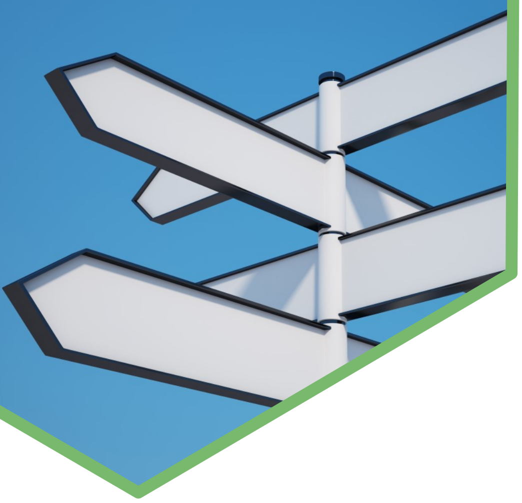
Owners are linked by one simple fact – when they decide to exit their business they want to make sure that they get the best deal, and getting the best deal involves planning for the final exit and presenting the business in the best possible light.

Exiting businesses should not be seen as a game of chance. Planning allows the business owner to remain in control of any process, and focuses the business on the most important, value enhancing strategies prior to an exit. At Cattaneo we believe that all business owners, where an exit is likely at some point in the future, should formulate an Exit Strategy.

EXIT STRATEGY

The exit strategy documents the following:

- **Current value of the business and its key value drivers;**
- **An evaluation of the possible exit options available at that time and in the future;**
- **The types of buyers who may be interested in buying the business, now or in the future, and why;**
- **Characteristics that may be unattractive about the business today and what may restrict the exit options and/or have a detrimental effect on exit values; and**
- **What the owners need to do to put these things right before exit.**



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WHAT IS AN EXIT STRATEGY?

An exit strategy can start at any time, but the sooner the better if it is to have an impact on external valuation achieved. For many owner managers, exit planning is left too late, although owners are becoming increasingly aware of the benefits of early planning. For MBO teams and their private equity partners, formulating a credible exit strategy usually takes place before they even invest their money.

One key benefit of formulating an exit strategy 12-24 months prior to an exit is the time it allows an owner to prepare the business for sale by focusing on improving areas in the business that are key value drivers to a buyer.

Generally speaking, the longer an owner has to groom the business, the greater the benefit. But one thing is for sure - by identifying and implementing an exit strategy, the final result will be improved.

KEY AREAS TO ADDRESS

There are several key areas to address when formulating an exit strategy:

- The exit alternatives and which is best for the business and its owners;
- The current value of the business and how it compares with the owner's price expectations. Is there a gap?;
- The future prospects for the business and the key threats to a successful exit;
- What does the business need to look like to be attractive to a trade buyer or institutional investor or would buying the business appeal to the existing management team;
- The opportunities for improving the value of the business in the time available and how can this achieved;
- How the exit strategy should be implemented.

FORMULATING AN EXIT STRATEGY

There are many reasons why owners of businesses start to think about seeking an exit:

- The owner may be seeking retirement;
- For an MBO or MBI the exit is part of the original investment plan;
- The business may require significant investment and hence a sale of all or part of the business is appropriate to mitigate an owner's risk;
- The owner may feel the market is as good as it is going to get, or even worse, they may feel it could deteriorate;
- Key employees may be seeking to retire and would be difficult to replace; or
- For large corporations, particular subsidiaries may become non-core through changes in group strategy, or there may be a need for additional cash.

HOW CAN OWNERS EXIT THEIR BUSINESSES

There are a number of ways for owners to exit their business:

- **TRADE SALE** – the business is sold to a trade purchaser either in the same markets or to a buyer that wishes to enter the target's markets or extend its business into the target's products.
- **INSTITUTIONAL PURCHASE** – a private equity house purchases the business, usually backing the existing management team ("Management Buy-Out" or "MBO") or a new management team ("Management Buy-In" or "MBI").
- **CASH OUT OR RECAPITALISATION** – the owner takes out some cash in exchange for part of its equity but retains an ongoing stake in the business, often alongside management, allowing a future sale at a higher price in the future. This could be funded by a bank and /or private equity house.
- **FLOTATION OR IPO** – the company's shares are admitted to trading on a public market providing a partial or full exit and a route to full exit in the longer term whilst benefiting from future increases in value.

In deciding on the best exit strategy the starting point is to identify what the shareholders are seeking to achieve. For instance, a weak management team may restrict opportunities to do an MBO, but may be less problematic to a competitor who has their own management.

Therefore the first step in formulating an exit strategy is to conclude what are the realistic exit options open to you.

TIMEFRAMES

Any owner looking to divest within two to three years should start to formulate their exit strategy now. Assuming six to nine months to complete the sale process and six to twelve months of employment with the purchaser to facilitate an orderly handover of the business, in most cases this will only leave six to eighteen months to get the business into shape.

For any manager considering putting money into an MBO (or MBI) there will normally be a clear view on how an exit would be achieved prior to the deal completing. By necessity this will of course evolve through the life of the MBO, but it is important to know at the inception what the credible exit options are that would be acceptable to both management and their financial backers.
For many owners it is the threat that the business performance has peaked and may start to deteriorate that gets them thinking about an exit. If this is the case then the exit may come too late to get the best price.

THE BUSINESS

Often businesses have no real competitive advantage in the market place but exist either through long-term personally built relationships or a degree of price competitiveness linked to hard work in servicing the customer base.

During the preparation phase you should seek to develop the unique selling points that are sustainable. These might include better trained managers who are then multi-functional, an increase in product development, re-branding or even a series of partnership relationships that enable a wider, differentiated and more guaranteed market penetration.

When exiting a business it is always important to leave some upside for the new owners, so that they can see continued growth once they have control of the business. An important part of the exit strategy, therefore, is to identify the immediate and medium term prospects of the business and be able to sell them as benefits.

These may include, for example, the following:

- **Exploiting a new product range;**
- **New geographical markets;**
- **New legislation supporting growth in a company's products or services.**

It may be beneficial for a company to have proved some of the upside in these areas by the time of exit to put some substance behind the claims of growth. Again this may take time to accomplish which emphasises the need to start the planning process early.

THE THREATS

It is not just the upside that owners need to think about when planning an exit – possible threats to a business can impact on the attractiveness and therefore value of a business.

WHAT MIGHT GO WRONG?

- **New and competing technology in a company's markets;**
- **An adverse change in legislation;**
- **Consolidation or loss of a customers.**

Some of these threats may not be defendable, though many will be. Again, the defence strategy may take time to implement and "bed in" (e.g. an acquisition prior to exit to acquire a desirable technology). Where a defence strategy is too risky or too costly, the answer may be to bring the exit forward before the threat becomes more severe.

Nothing turns a prospective purchaser away from a business more quickly than inaccurate, incomplete, or delays in receiving, information. Consider the information you would wish to see if you were purchasing a business and ensure that this has been recorded for at least two years prior to the sale. This should include: robust monthly management accounts; customer and product concentration details; margin analysis etc; all reconciled through to the statutory accounts.

The structure of a business should be as tidy as possible to prevent complications and additional costs arising. The area is complex both commercially and tax wise and ideally should be addressed with your adviser as far in advance of the sale as possible. Areas that sometimes cause problems are: minority shareholdings held by potentially problematical parties; over complicated group structures; inter-company or related party trading; and underlying results not visible from statutory or management accounts.

VALUATION

IMPORTANT ASPECTS OF THE EXIT DECISION

The exit strategy will drive out many important aspects of the decision to exit.

- **Is there an optimum time to exit?**
- **What is the current estimated market value?**
- **Does the business currently look attractive to new investors?**
- **Will the business exit on a rising level of profitability?**

If it is apparent that the owners wish to sell as soon as possible and the current market is strong, it may be attractive to market the business sooner rather than later.

For many other owners the exit decision is more complicated, and involves balancing up competing objectives. Quite often these revolve around the current valuation, in particular if its less than the owner would like to achieve. In many ways this can act as a catalyst to the preparation process as an owner looks to pursue a strategy to improve the exit valuation.

The conclusions of the preparation phase can potentially influence both the timing and likelihood of any exit. It will also, importantly, identify any gap between the current valuation of the business and the value sought by the vendor.

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 the Equity Value, that is the value attributable to the shares.

EXAMPLES OF WAYS TO INCREASE VALUE

PROFIT IMPROVEMENT

- Acquire businesses on lower valuation multiples to boost profits;
- Increase turnover by reviewing selling prices;
- Margin management, e.g. bringing sub-contract processes in house or losing less profitable work;
- Manage overheads to cut out excesses or minimise increases.

PRICE RATIO

- Reduce reliance on key customers /suppliers;
- Demonstrate the business has growth opportunities in new markets or products;
- Legally tie in key employees and make sure intellectual property rights are in order.

RESOURCE USE IMPROVEMENTS

- Reduce working capital to free up cash and improve equity value;
- Delay non-critical capital expenditure;
  and increase return on capital;
- Generate cash from the sale and lease back of major assets (e.g. property).

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 similar 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. The latter can also provide an indication of a listed purchaser's ability to raise funds for a transaction.

In addition to 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.

Increasing the value of a business can be achieved by either increasing the profits, enhancing the value of the price multiple and/or resource use improvements.

Each opportunity has a timescale and therefore one of the key things to consider at this point is the desired exit horizon of the owners. It may be impractical to consider an acquisition, for example, if the business does not have time to fully merge the two businesses to gain the synergies of the merger. Essentially, an owner is left with a list of what they believe to be achievable targets that becomes the exit strategy of the business prior to exit. Without proper implementation of course, the likelihood of any significant change (and consequently of any benefit) is small.

OWNERSHIP OF THE STRATEGY

The exit strategy needs the full support of those allocated the responsibility for delivering the targets set. This may be restricted to the owners of a business, but very often involves non-shareholding management. Most owners prefer not to disclose their intentions around exit, whilst others may be more forthcoming.

The pros and cons of disclosure need to be weighed up and incentive arrangements can be put in place to align and motivate non shareholder key management with the exit strategy. Your adviser will have first hand experience of such incentive arrangments and can advise you how best to structure something to fit the circumstances.

Implementation is not a one-off process, and the exit strategy needs to be reviewed on an ongoing basis to ensure value benefits are been delivered. In the main this is an internal process, although in our experience the process can be significantly improved by involving an external adviser or appointing a suitable non-executive to the board to bring their experience and external point of view to the business.

FREQUENTLY USED TERMS

Business and Asset Sale – the sale of the business and assets of a company by the company itself such that the company receives the consideration and realises the capital gain, which is taxable on the company. The consideration then needs to be extracted from the company with potential further tax consequences.

Cash and Debt Free – companies are normally valued on a cash and debt free basis which means that the existing capital structure is ignored for valuation purposes on the basis that the purchaser will utilise an alternative funding structure. Once a value for the business is derived (the Enterprise Value) the value of the shares (Equity Value) is obtained by deducting the amount of debt and adding the amount of surplus cash.

Due Diligence – the process by which a potential purchaser makes enquiries and gathers information on the target in order to confirm or evaluate the business – due diligence can be financial, legal, commercial, technical or of any other nature relevant to the potential purchaser's evaluation of the target.

Earn Out – the deferral of a portion of the consideration, the payment of which is contingent on the future achievement of pre-defined targets, most commonly, but not exclusively, profit-based.

Exclusivity – agreement by the seller to continue discussions with a single party in return for that party incurring time and cost on due diligence and legal contracts.

Grooming – often used to refer to operational improvements in preparing a business for sale e.g. maximising profits and cash flow, filling any gaps in management, ensuring contracts are in order and resolving any outstanding disputes.

Heads of Agreement or Heads of Terms – a document that sets out the key terms agreed between buyer and seller as the basis for progressing to due diligence and legal contract – it is normally non-binding except for certain terms relating to exclusivity and costs.

Indemnity – an agreement by the seller to compensate the purchaser for a loss suffered as a result of the occurrence of specific circumstances.

Information Memorandum – a document prepared by the seller that describes a business for sale and sets out the information required by an interested party to evaluate the business and formulate an indicative offer.

Indicative Offer – an initial, non-binding offer made by a potential purchaser which will qualify it (or not) to progress in the sale process and enter into more detailed discussions with the vendor.

Management Presentation – qualifying bidders are often invited to receive a presentation from the company's management (prepared with the assistance of the vendor and its advisers) which has the intention of cementing the bidders' interest and encouraging them to make their offers as competitive as possible.

Non-Disclosure Agreement (NDA) or Confidentiality Agreement – a legally binding agreement whereby the vendor agrees to disclose certain confidential information (e.g. as contained in an information memorandum) in return for the recipient agreeing to keep the information confidential and not use it for commercial advantage.

Normalised Working Capital – when adjusting for net debt (or cash) to derive an Equity Value from an Enterprise Value it is important to take into account any seasonal, or even daily, fluctuations in working capital (that directly affect the debt / cash position of the company and therefore the Equity Value). Working capital is usually "normalised" by removing unusual fluctuations, adjusting for non-sustainable changes and averaging out seasonality or other short term fluctuations.

Restrictive Covenant – an obligation by a vendor not to compete with the business that has been sold for a defined period of time, normally one to two years, in order not to undermine the value of the business.

Sale, Disposal, Exit – the sale of the shares in a company or of a company's business and assets.

Sale and Purchase Agreement (SPA) – the legal contract between buyer and seller that sets out the terms of the transaction including details of the quantum, form and timing of the consideration and the obligations of the seller in terms of warranties and indemnities.

Share Sale – the sale of the shares in a company such that the shareholders receive the consideration and realises the capital gain, which is taxable on them.

Sustainable or Adjusted Profit – the profit stream that is being sold i.e. after making adjustments for non-recurring items such as shareholder costs or one-off costs or income such as the disposal of surplus assets.

Teaser – an anonymous summary of a business which allows a party to confirm its interest before it enters into an NDA and receives more detailed information, including the name of the business in question.

Vendor Due Diligence – due diligence investigations that are commissioned by the vendor but which can be relied upon by bidders – normally used to keep multiple bidders in the process longer thus maintaining competitive tension and also shortening the overall timescale.

Warranty – an assurance given by the seller that facts on which the purchaser is relying are true.

WHY CATTANEO

You need an experienced corporate finance adviser with a proven record of advising shareholders and corporate owners on selling 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.

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

Cattaneo LLP Tel: +44 (0) 121 274 2300

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