Buying a business

Buying a business can be a big step forward, or it can turn out to be disastrous. This briefing assumes that you have already found a suitable business (the target business).

It explains how to complete the purchase of the target business, including checking what state the business is really in.The main pitfalls tend to be similar, regardless of how large the target business is.

This briefing covers:

- Approaching the target business.
- Completing due diligence.
- Negotiating the purchase.
- Settling the purchase once it is completed.

1 The initial approach

From the outset, your aim is to make the vendor want to sell the business to you.

1.1 Establish your **credibility**.

- Formally register your interest in buying the business. The target business will usually have instructed professional advisers to sell the business. Approach the advisers, rather than the management.
- Explain what your business is, why you are interested, and how you will finance the purchase.
  Your integrity and your future plans for the business are usually extremely important to the vendor.

1.2 Work out the **vendor's objectives**. For example:

- Does the vendor have to sell? If the answer is yes, what time pressures are they under?
- Does the vendor wish to sell assets or a company which holds assets?
- Is money the prime motivation for selling?
- Does the existing management aim to stay involved in the business?

  Expose areas of the business which need to be changed.

2 Preliminary due diligence

You must be sure that the business has no major problems. Preliminary 'due diligence' is completed before you make a firm offer for the business. The vendor's Sales Memorandum usually glosses over the weak areas.

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2.1 Get a **feel** for the business.

- Research its market and its main competitors.
- Meet the vendor. Try to visit the business.
- Assess the key risks associated with the business' future trading.

2.2 Ask **industry experts** for their views.

- What is the prospective demand for the business' products or services?
- Are prices (and margins) rising or falling?
- How is the competition in that market changing? For example, which new competitors are entering it?

It is unusual to have much access to a business before an offer has been accepted. Wait until you have agreed 'Heads of Terms' (see **5**) to do a more thorough investigation.

3 Professional advisers

3.1 Choose advisers with appropriate **experience**. You may need experts in several different areas, at different stages. For example, specialists in:

- Market research, accounting, tax and legal due diligence.
- Financing the purchase.
- Employee terms, for example, pension fund provisions.
- Negotiating the deal.

  Ask what the last four deals were that the adviser worked on. Ask to speak to the four clients about their experiences.

  This approach quickly reveals which advisers are good. You can also pick up useful tips on buying a business.

3.2 Draw up specific **remits** for your advisers.

- Explain in writing what your advisers should (and should not) do.
  For example, you could ask a financial adviser to analyse projected margins for orders over £5,000.
- Co-ordinating more than one adviser can become complicated. Agree to use planning documents, such as a 'completion checklist'.
  Give advisers a timetable for the work.

3.3 Agree **fee levels** as clearly as possible.

- Advisers normally charge by the hour. Agree a target number of hours for each stage of work, and a system for keeping you regularly informed of costs.
  Negotiate a limit on the maximum fee.
- Advisers may charge by the job.
- Fees may be on a contingency basis, dependent upon the deal completing, or on the price.
  For example, you might pay an adviser a percentage of any reduction achieved in the price.

4 Making an initial offer

4.1 Take professional advice to help you **value** the target business.

- Make your own profit projections. Do not rely on the vendor's figures.
  For example, question claims that the gross margin is going to increase.
- Identify where savings can be made, and where there is scope to increase profits.
  For example, can your existing business also grow by selling to the target business' customers?

> "Using inexperienced advisers will, at best, impede the process. At worst, you will lose the deal or pay too much or get landed with unforeseen liabilities."
> **Paddy MccGwire, Cobalt Corporate Finance**

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

- Has assets worth less than your offer price.
- Relies on one or two major customers (or contracts, or suppliers, or key employees).
- Is currently unprofitable, or has a history of losses.
  You may have to fund losses for some time to come.

  Heavy borrowing to finance the purchase may also increase your risk. Conversely, the lack of adequate finance may have been all that was holding the company back.

4.3 **Calculate** your initial offer and your maximum offer. Take into account:

- Your initial valuation.
- What competition you are up against.
- The vendor's objectives.
  Assess what you are prepared to pay and be able to articulate why. Be prepared to amend the basis for your offer if necessary.

4.4 **Submit** your offer.

- Use a concise, formal letter. Head it 'SUBJECT TO CONTRACT', so that you are not committed.
- Detail the specifics of what you are prepared to pay and what you'll expect to receive for it.
- Emphasise the positive points of the offer.

For example, that you can pay in cash or that all the employees will be kept on.

4.5 Chase up the offer.

- Clarify any outstanding issues.
- Listen carefully to feedback on your offer and be prepared to revise terms if necessary.

5 Signing Heads of Terms

The 'Heads of Terms' agreement sets out the main terms of the sale. (This is also called 'Heads of Agreement').

5.1 Specify **what** you have agreed to buy.

- This may be the business, or just its assets.
- By buying just the assets, you avoid potential legal liabilities, such as a legal action based on a previous contract. For example, you might buy the fixed assets (equipment etc), stock, debtors and orderbook — and re-employ the people.

5.2 Set out the **payment** structure.

- The amount may be tied to the profit figures in the next set of audited accounts.
- Parts of the payment may be deferred (see box).
- Payment can be complex. For example, it could involve shares in your own business.

Buy now, pay later

Deferred payments can benefit both sides.

A They allow you to pay using **cash** generated from the business itself.

B They allow you to suggest an '**earn-out**' payment.

- The amount of the final payment depends on the business' future performance. If profitability falls, you end up paying less.
- You can also link payments to the winning of a key contract, or a similar business milestone.

C They may lower the vendor's **tax** bill.

- Capital gains tax on the sale can be spread over more than one tax year. So can income tax on any consultancy payments.

5.3 Agree a period of **exclusivity**.

For example, the vendor might be prevented from speaking to other buyers for a ten-week period.

- Try to negotiate that your professional advisers' fees will be reimbursed if the vendor pulls out of the deal.

5.4 List any **preconditions** you insist on. For example, the achievement of a particular result (eg a minimum level of audited profits or firm orders, or the sale of an asset).

- You are only committed to purchase the business if the preconditions are met.

5.5 Agree which **warranties** and **indemnities** will be provided by the vendor.

- Warranties are written statements which confirm certain key information about the business. For example, covering business assets, audited accounts, orderbook, debtors, creditors, employees, and legal claims.
- An indemnity is a commitment to reimburse you (the buyer) in full, in a specified situation. For example, you usually receive a tax indemnity, to cover any undisclosed tax liabilities relating to transactions before the date the business was sold.

6 Detailed due diligence

After signing the Heads of Terms, you should make a thorough examination of the business. This is the second stage of due diligence.

6.1 Seek out **customer's opinions**. Ask them:

- How long have they been customers?
- Who is their main contact at the business? If this is the owner, his continued involvement will be more valuable.
- What is good and bad about the business' products or services?
- Do they use competitors? What are their comparative advantages?
- What will the customer's future demand be for the business' products or services?

6.2 Ask **suppliers** for their views.

- Does the business pay on time?
- Is it an efficiently run business?
- How does it compare with competitors?

6.3 Analyse **historical information** and trends.

- Look at sales growth, profit margins, overheads and working capital (debtors, creditors, stock and work-in-progress). What is the scope for improvement?
- Check for inconsistencies. For example, the business may recently have changed its accounting policy to increase the book value of stock (and therefore profits).

6.4 Compare the business' **financial projections** with other evidence you have.

- Do they tally with the historical trends? For example, are the debtor period and the bad debt provisions realistic?
- Is the sales forecast achievable, given the current orderbook and the statements by customers? Does it reflect the outlook for the industry and the whole economy?

Revise the business' projections, if they are out of step with these indicators.

6.5 Check up on major **balance sheet** items.

- When was the last full audit? If it was over six months ago, do another one.
- What are stock levels? Rising stock levels may be a dangerous sign, especially in manufacturing, seasonal or fashion industries.
- How large are the business' bad debts?

6.6 Consider doing an **employee audit**, if you are allowed access to the business. This involves looking at:

- Who the key employees are, so you can plan how to run the business.
- General skill levels, employee turnover, and pay, compared with industry averages.
- How employees feel about a change of ownership. Would you expect any to leave? If so, would the key people stay?

6.7 Complete **legal** due diligence.

- Confirm legal ownership of all key assets. This might include property, equipment, vehicles and intellectual property (eg registered patents, copyright).
- Check for any past, current or pending law suits.
- Examine all contractual obligations. This includes employment contracts (including any pensions), and contracts with third parties, such as customers and suppliers. Look for contingent liabilities. Consider what effect a change of ownership will have. Some contracts may be nullified as a result.

7 Negotiating the final terms

If your due diligence checks have been thorough, you should be in a stronger negotiating position. The problems and weaknesses you have uncovered may lead you to lower your offer, or to ask for tougher warranties and indemnities.

7.1 Be **reasonable** but firm in making requests.

- Explain the reasons behind your requests.

7.2 Keep the **dialogue** going, even if the process becomes awkward.

- The vendor is unlikely to withdraw at this late stage. Brinkmanship and all the other aspects of negotiation come into play.

7.3 Close the **deal**.

8 After the completion

To ensure a smooth transition, there are two priorities.

8.1 Quickly announce the **change of ownership**, in a positive way.

- Agree how it is to be announced, and the wording, with the vendor. Make the announcement positive.
- See the employees individually, if possible. It is important to make them feel settled and motivated from the outset. Under EU rules, businesses with more than 50 employees have to notify and discuss, with their employees, any changes likely to affect their jobs.
- Write to the major customers, explaining the advantages for them.

8.2 Implement your **action plan**.

This plan will have evolved during the whole buying process. Complete it before you make the final offer, including a timetable. The plan outlines all the steps necessary to achieve key objectives such as:

- Establishing trust and confidence in the future, among the employees.
- Securing, and then improving, customer relationships.
- Focusing the business, to improve cashflow and profitability. Make clear to employees your determination to carry through your plans.

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