Fédération des
Experts Comptables
Européens

HOW TO PREPARE THE SUCCESSFUL SALE OF AN ESTABLISHED FAMILY BUSINESS

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INTRODUCTION

This paper is primarily addressed to owners of family businesses who wish to sell their business. The paper will also be of interest to professionally qualified accountants who are in practice and have the necessary skills to give advise to clients on the sale of their business.

For the purpose of this paper "family business" is defined as an unlisted business managed and owned by the family, independent of the size of the business.

Establishing a family business that can be passed from one generation to the next may be the dream of the founder, but not necessarily of the inheritors. Such family business succession invariably requires willing and able younger generations, as well as careful planning. This requires a good succession plan which takes into account the needs and interests of all the generations in the family. The issues involved are discussed in the FEE booklet, Keeping it in the Family: SME Family Business Succession [1].

Where succession is not viable, family business owners will need to find other ways of disposing of the business. Selling the business is an important option. The good news is that the market for buying and selling small firms is highly active. For example, on average each existing business in the UK has acquired one other firm in the last five years[2].

Sales to other companies within the same sector are the most common form of external disposal. This reflects acquirers' primary motivations of gaining market share and economies of scale, as well as desire for diversification into new products or markets and vertical integration.

This paper discusses the general principles of selling an established family business and therefore the content should tailored to the particular circumstances of a sale.

When planning the long-term strategy of the business, the family should bear in mind the possibility of an approach from another business to sell their business. Thus, the paper is addressed not only to the family business which is planning to sell, but also where the family business may receive an offer to buy the business.

The nature of the acquisition of the family business may also be achieved through a management buy-out or a buy-in. In general, these forms of acquisitions are increasingly popular. According to figures from the Centre for Management Buy-Out Research at the University of Nottingham, in the year 2000 the total value of UK MBO and MBI deals reached €38.9bn, the highest total ever recorded. In the main however, this activity relates to large companies. These are increasingly popular and are considered in more detail later.

Buy-out teams are potentially attractive purchasers, given their obvious knowledge of the company. In contrast, buy-in teams tend to rely on networks of venture capitalists and accountants to find their acquisitions.

[1] Fédération des Experts Comptables Européens and ACCA (2000) *Keeping it in the Family: SME Family Business Succession*

[2] Hughes, A. and Storey, D. (Eds) (1994) *Finance and the small firm*, Routledge

Despite the range of sale options, owner managers can find the prospect of selling their business a disturbing one. Professor Sue Birley of Imperial College has demonstrated how strongly issues related to the future continuity of the business feature on the entrepreneurial worry list[3]. Some 28% of her research sample said the issue of whether or not to sell the business was a fairly constant worry, while 22% admitted to having nightmares about selling. A significant 27% worried about how they might find a buyer and 20% said the problem kept them awake at night.

Careful preparation can do much to lessen such fears. However, it may take several years to take a business from the decision to sell to the point where the business is ready for disposal. Ill-prepared vendors can find themselves being haggled down from their named starting price. The paper gives much emphasis to planning and carefully details the essential features of the planning process.

The sale and purchase transaction involves many decision points for both buyers and sellers. Both parties can choose to act independently, or through specialists such as business brokers and corporate finance boutiques. They may choose to rely on trade contacts or tap into business angel networks. They may decide to draw heavily on the technical expertise of lawyers and professional accountants, or do much of the groundwork themselves. The role of the advisor is considered in this context.

For vendors, achieving a successful sale requires careful preparation and a considerable investment of management time. It is important, for the seller, to have an understanding of the motivation of the purchaser. This paper examines the process of selling an unlisted family business from the perspective of the vendor but also examines some of the motivations of the acquirer.

[3] Birley, Professor S. (2000) *Children and the Family Business, The PRIMA International Research Report*, Grant Thornton

1. GETTING READY

Why sell?

The need to sell the business may arise suddenly, or may be a result of months of deliberation conducted when the owner is under no pressure to sell. Either way, the primary concern for the seller must be getting the best price.

There may be a number of compelling reasons for making a sale which include:

- increasing competition
- the business becomes too big
- to take advantage of tax relief
- new regulations
- new technology
- falling demand
- disposal of part of the business for strategic alliance
- forthcoming retirement
- a lack of suitable family members willing or able to run the business
- ill health
- liquidity problems
- an excellent offer has been received.

Where possible, the vendor should try to make sure that the disposal is planned well in advance. Planning should identify all the sale options and potential buyers. If the decision is rushed, there is a risk that all potential purchasers will not be aware of the opportunity to buy the business and may not be fully prepared themselves to put in an offer.

Taking the decision to sell at an appropriate time is particularly important if the vendor suspects tough times ahead. An owner manager forced to sell because cash flow has deteriorated to the point where the business is unsustainable is unlikely to achieve more than a fire sale price. The pool of purchasers will be small and they will be concerned about the weakness of the business.

The vendor must be prepared for the sale to take some time to get the best price, particularly if economic conditions are unfavourable or if the industry is in recession. The time from the decision to sell to completing the sale may take years rather than months.

Finally, many businesses are sold because they receive an unsolicited approach from a buyer. Such offers must be considered with the same commercial sense as if the vendor had taken an unprompted decision to sell. If a sale is appropriate, the unsolicited offer may not itself deliver the best price for the business and it may well be worth considering strategies to encourage other offers.

How to identify a potential buyer?

Once the decision to sell has been taken and the reasons for making a sale have been duly considered, the vendor must acquire a clear vision of where the market it is going and identify potential buyers.

With a commercial rationale established there may be a number of competitors or operators in the same market that could be targeted for the acquisition. From this perspective the vendor should take into consideration:

- the current state of the market
- the future expectation of the trends
- the competition of the sector
- the new technology
- the geographic position of the business.

Customers or suppliers may also be interested in the acquisition thereby expanding their markets from a vertical perspective. Customer and supplier lists should be carefully scrutinised so to target potential buyers followed by some more intensive research about the potential acquirer before an approach is made. In terms of the approach to either a customer or supplier it may be wise to use the firm's external accountants as they may be seen as a more independent party.

Other potential buyers may be identified by the vendors bank and other external advisors and parties.

What will the buyer look for?

Possible commercial rationales for wanting to buy a business

The buyer will look for a business that will allow him:

- To increase market share

  This may enable a business to obtain greater control of the market in which they operate.

- To increase profitability

  This may result from cost savings through synergies or increases in sales prices because of reduced competition.

- To broaden the range of products or services that the business can offer

  There may be obvious opportunities to boost sales through expanding into related activities. For example, if the business in question is an organic farm it could acquire a restaurant that would make use of its produce.

- To achieve rapid growth

  Acquiring a business may be quicker than building one from scratch, or may allow rapid expansion into an adjacent business segment.

- To enter non-EU markets

  Acquiring an established non-EU business may be cheaper than setting up a new branch, and will certainly build sales more quickly.

- To turn around a loss-making business

  Acquiring an under-performing business can be appealing if the acquirer has the turnaround ability to transform poor results into significant profits. However, specialist skills are required and running an existing business well is no guarantee of success in a turnaround scenario.

- To buy into a new technology

  Buying into may be less expensive than the business developing the new technology.

- To acquire a well-known trademark (or a know-how)

  This is where the buyer is of the opinion that they can commercially exploit a trademark to a greater extent than the current owner of the trademark.

- To develop the distribution capability

  To buy into a business with an established distribution capability may be less expensive than creating one.

- To invest surplus funds

  This is an appropriate reason for an acquisition if the deal is itself consistent with the overall strategic plan of the business.

- To compensate losses carry forward

  Acquiring a business that is carrying losses could help for tax planning reasons.

The Expectations of the Buyer

The buyer will expect the business to be acquired to have:

- a good quality of the financial information

- no significant risks above normal expectations

Purchasers are wary of exposing themselves to unlimited liabilities following an acquisition and will seek protection. For example, the purchase of an engineering business collapsed when the buyer asked for massive warranties related to the possible costs of cleaning up contaminated land.

Potential acquirers will be put off by any business undergoing even a routine investigation by the tax authorities, or even notified of an forthcoming investigation. There is always the risk that the tax investigation could uncover problems that have to be addressed, for example, concerning director or staff benefits in kind.

There may be doubts about the capacity of a poorly managed business to meet regulatory requirements.

If the deal requires a new factory or office space to be built, doubts about planning permission being granted could jeopardise the deal.

If a company pension scheme has been set up for staff, the acquirer will be concerned about the extent of pension fund liabilities.

Certain personnel may be key to the current success of the business, as well as its performance in the immediate future. If such people are likely to leave on the sale of the business, and cannot be induced to stay at least for a pre-agreed short-term period, the acquirer may pull out of the acquisition.

- no litigation risks

  Buyers will be wary of businesses in the midst of legal actions. For example, say a business is sold while in dispute with a customer over the applicability of a warranty. Under the sale agreement the final cost of the business to the purchaser could be made contingent on the result of the dispute.

- fulfils environmental legislation

- not dependent on a single or very few customers

- no cash problems.

Litigation threat scuppers a sale

Jim Smith built up a successful specialist springs manufacturing business. Over a number of years he created a core UK customer base and then expanded his sales to include the USA and Canada.

Having reached his late forties, Jim decided the time was right to realise the value he had created and began looking for a purchaser. There was considerable interest from companies in the UK and abroad and Jim was hopeful of a quick sale.

He then unexpectedly received a letter from the legal representatives of a significant US corporation who claimed an infringement of patents. Jim contacted his lawyers, who advised him that the claim had little substance to it. However, once the potential purchasers were informed, their interest immediately dried up.

Jim resigned himself to putting the sale on hold until the legal issues had been dealt with. His corporate finance advisers told him that no purchaser would pay a reasonable price for the business until the litigation threat had been resolved.

The importance of setting a realistic acquisition strategy

Starphones was one of many mobile phone repair and service businesses established in the 1990s. The market was extremely competitive; while the demand for phones and services increased, so did the number of players in the market place. There were many operators, a large number existing only for a year to eighteen months. No local firm was able to establish a particularly strong position or, indeed, was notably profitable.

To "take the business forwards" in the face of very tough competition, Starphones decided to acquire Phones Are Us. Directors believed that this acquisition would "combine strong service and retail networks", while extending the core service business out of their area they have been operating in the past.

However, the acquisition did not deliver expected returns. The directors had failed to take account of the growth of digital technology, which undermined demand for the servicing of analogue phones. Having made an acquisition, the business was reluctant to borrow to buy the equipment necessary to service digital phones. Already tight margins fell further. The problem was worsened by the inability to service digital phones brought from retailing outlets. Contract repairers proved unreliable and expensive.

The business went into receivership 18 months after completing the deal.

2. DRESSING YOUR BUSINESS FOR SELLING

Preparation holds the key to successfully selling a business. Cutting corners could lead to long negotiations, a slow sale and a disappointing price.

Before seriously starting to look for potential acquirers, vendors need to spend some time grooming the business. The aim is to present the business in its best light, with profits on a healthy upward graph, in order to achieve the maximum sale price.

Any kinks in the financial picture need to be ironed out before the business goes on the market. This can mean reviewing accounting policies and generally trying to make the accounts as 'clean' as possible. The process can take considerable time. It is worth starting to think about such issues several years before the desired disposal date.

Business planning should be continued as though ownership will remain in the current owners' hands. This is the best way to continue generating profits and to demonstrate the future profitability of the business.

As previously mentioned this guide relates to the entire sale of the business there will be other considerations if only a part of the businesses is to be sold.

Particular issues to be considered include:

- Outstanding operational issues

  Any such issues, such as staffing, customer and supplier problems, should be resolved. The vendor needs to demonstrate a strong customer base and healthy supplier relationships.

- Control or other weaknesses

  The purchaser is likely to be concerned by failures to follow good practice. For example, irregular or poor financial information or weak credit control will certainly slow down the sale.

- Matters relating to provisions

  Any outstanding provisions should be settled so that a problem can be eliminated. If a business is to be valued on a profits multiple, eliminating large provisions should have a significant effect.

- Managing risks

  Risks should be identified and strategies for managing these risks should be established. It may be to the sellers advantage to demonstrate to the potential buyer that the process of identification and hedging has taken place thereby giving the buyer further confidence in the sale.

- Contingent legal and tax liabilities could hinder the sale

  It is important to identify any potential legal or tax liabilities and attempt to resolve them prior to negotiation of the sale.

- Loan form

- What would be the better legal form to get a buyer? Re-structure your business?

  The consideration of legal form may be influential in attracting buyers. For example, it may be that a company with limited liability would be more attractive than a sole tradership or a partnership because of the potential liability.

- Quality of the management information records

  A critical element in the assessment of the business by potential buyers will be the quality of information. The quality may be enhanced in many ways including an audit and comprehensive explanatory notes in support of figures.

- Keeping up to date with modern legislation

  Demonstrating that the business keeps abreast of newly enacted legislation e.g. health safety may be influential in a sale.

- A balanced structure of customers

  Dependency on one or a few customers will enhance the risk of insolvency. A wide portfolio of customers is likely to lessen this risk.

- Remuneration packages

  Onerous directors contracts that continue post the sale of the business may have a detrimental on the sale.

- Influence of unions and employees

  The legal rights of staff, for example, European Directive 77/187, known as the Acquired Rights Directive, provides a certain amount of protection to employees in acquired businesses. Where the above mentioned Directive applies, as in the sale of a business which is a going concern, many employee rights are automatically transferred to the new employer, including terms and conditions of employment. This is a very important issue in each one of EU Member States. For example in the Germany, there is a high influence of the workers and unions in businesses. In Italy before the sale, the Trade Union should be consulted.

3. FINDING THE BUYER

The biggest problem most unlisted family businesses face is the lack of a open market where bidders set prices competitively. The biggest problem faced by potential buyers is knowing when an opportunity to buy exists. That is, there is a information gap!

Sources

Vendors can consider the same sources as those available to the acquirers. However, there are certain points to bear in mind:

- For the vendor to be listed in a Disposal register may send the wrong signals to potential interested acquirers. It may suggest that the business is not attractive enough to be sold any other way. Registers run by accountants, however, may have the benefit that advice may be available on the sale process, including pre-sale grooming

- Where the business is advertised or a business brokers is used respondents must be tied in to respect confidentiality. Most brokers do not provide professional advice, although there are exceptions.

Target groups could include:

- Non-EU companies in the same sector, with interests in the EU but without a local operation

- EU companies with a product or service gap, or in the same broad sector but wishing to diversify

- Businesses that wish to catch up with technology

- Customers and suppliers

- A management buy-in or buy-out team

- Direct competition – but treat with caution as they may only be after confidential business information.

Is the buyer serious?

There is usually a vast spread between offers made for a business. Research shows that out of four offers, the highest will be at least 50% higher than the lowest. However, the vendor needs to make sure that these are all serious offers and should try to obtain formal written bids, without entering into any exclusivity arrangements, before going down the aisle with one purchaser.

As mentioned above, an unsolicited approach on the doormat can be attractive, but should be treated with care because it:

- may not secure better value than keeping the business in the family
- may not secure better value than opening the process up through brokers or advisers able to attract a range of bids
- may be a time-wasting exercise if full commitment is not received from the potential buyer throughout the process. The proposed buyer in fact may only be trying to get hold of competitive information and may have no intention of making an offer.

In short, it is essential to ensure that the offer is bona fide.

Using a business broker

An established business broker deals with companies with a net worth between €1.66m and €41.6m, although primarily €8.3m or less. Its objective is as follows: "To meet the need of owners of private businesses to find a better way of achieving a confidential sale at the best possible price."

The broker seeks to do this by the effective use of the network of accountants, lawyers and actuaries that it has developed. The firms within this professional network all feed vendors and purchasers into the broker's marketplace, performing a form of screening so that only serious vendors and buyers make it through. The broker's experience shows the value of such screening; between 80% and 90% of vendors who approach the broker *directly* are rejected because their businesses do not support the prices they seek.

Once a business for sale is referred to the broker, a dedicated team of staff conduct an in-depth study of the business with the proprietor to develop a strategy and prepare a sales document. An initial anonymous sales notice is circulated by the network's member firms and the broker then chooses the half dozen or so of the best suited bidders who respond. The broker provides a discrete marketplace, with the bidders never knowing the name of their potential target until they have put themselves firmly in the market to buy. It is up to them to make offers, in competition with an unknown number of rivals. The broker's staff guide the vendor through the process of negotiation with the potential buyers, typically achieving a higher price than any earlier offer received through a direct approach.

One of the major benefits of the broker's in-depth research is that it can identify companies that are the right fit: a good fit means a higher price. Another benefit is that the risk of a post-sale dispute and subsequent litigation is minimised. The broker's approach appears to be successful. Having come to the broker, one loss-making publishing house was sold to the same publisher it had previously approached directly for a sum several times the original bid.

4. BROKING THE DEAL

The first step

Inevitably detailed negotiations are required for an agreement between the buyer and seller as to the value of the business to be sold. From the vendor's perspective the foundation of any valuation will be a series of calculations of profits and cash flows, assets and liabilities, although many less quantifiable factors may also come into play.

When considering past profits and cash flow information, any events that have distorted performance over preceding years need to be discovered and accounted for as it is likely that this information will play a part in determining any future value of the business. The valuation must reflect the vendor's forecasts of future earnings of the business. The past is only relevant in terms of a reference point to forecasting future earnings. This will involve identifying past trends in earnings during for example cyclical economic climates.

The vendor needs to establish the a minimum price acceptable and the highest price that could be achieved. These to values will act as reference points to the vendor in negotiations.

It should be recognised that the potential purchaser may well reflect significant differences in future earnings of the business in the valuation. The future earnings will be based on how the purchaser will use the assets acquired to generate earnings. This information will not necessarily be available to the vendor. It is important therefore that the vendor obtains as much information as possible to the acquirers intentions so that this can be considered in the vendors own valuation of the business.

Setting a valuation[4]

There are a number of quantitative techniques that can be used for establishing an initial valuation of the business. This value can form the basis for negotiations that then take into account the non-quantifiable or less tangible elements.

The most used valuation procedures are the capitalized earnings and the discounted cash flow (DCF) methods. They are based on the same conceptual framework (present value calculation). In both cases the present value of future business profits is calculated. Conceptually, both objectively determined entity valuations and subjective valuations can be established using either valuation procedure. Where the valuation assumptions or simplifications are the same, particularly with respect to financing, both methods lead to the same entity valuation. In practice, if different valuations are determined using both procedures, this is due to different assumptions, particularly with respect to the financing structure, risk premium and other forecast data used.

The capitalized earnings method calculates a business's value by discounting the future business profits flowing to the entity's owners, which derives from future commercial profits (statement of earnings).

[4] FEE devoted a complete guide on valuation of businesses, *Business Valuation: a guide for Small and Medium Sized Enterprises* (2001).

DCF methods determine the valuation of a business by discounting cash flows. The cash flows represent expected payment to the provider of capital. This is defined differently depending of the procedure used. Whereas the market value of equity is determined indirectly as the difference between the enterprise value and the market value of debt using the weighted average cost of capital method and the adjusted present value method, the equity method determines the market value of equity by discounting cash flows net of cost of debt using the return on equity (cost of equity). The concepts of weighted average cost of capital and adjusted present value are based on gross values (enterprise value methods), whereas the concept of direct calculation of the value of equity is based on net capital. Regardless of the difference in the method used, the individual DCF procedures result in the same values.

Simplified price determinations are sometimes used for SMEs. These determinations include the use of earnings multiples, or sales or product quantity-oriented multiples.

Simplified pricing methods can be a basis for plausibility checks of the results of the valuation using capitalized earnings or DCF methods.

If there is a difference between the earnings-based value and a value using a simplified price method for plausibility control purposes, this could be a reason for carrying out a critical review of the data and assumptions used for the valuation and, adjusting the valuation, to the extent additional knowledge is obtained (e.g. with respect to expected profits).

In his valuation report the adviser should clearly state the extent to which, and with what consequences, simplified pric ing methods have been used.

The initial investigation

Exploratory meetings allow the purchaser and vendor to form an initial view of the other party. The vendor should require confidentiality throughout the process, even during this initial investigation stage. To preserve confidentiality, these meetings should be held offsite.

An initial meeting should be arranged to sort out the broad format of the deal, to allow issues to be aired and to create trust. It must be remembered that there is no right price for a business and many of the issues are matters of highly subjective judgement.

The vendor should aim to find out as much as possible about the purchaser to assess the strengths of the bid. At the same time, the vendor will want to emphasise the opportunities available.

The following details some specific issues which may be relevant to negotiations:

- **Any assets retained**

  What happens to the outgoing assets that interest the current owner, which not affect the running of the business.

- **Earn-out features**

  An earn-out, where total consideration is dependent on performance over a period of years, may suit both sides as a way of meeting the price expectation of the vendor while protecting the purchaser. Both sides may tie it to high or low cash flow projections used as part of the negotiating process, the purchaser making higher payments if higher profits are generated. For the purchaser, it may also be used to tie elements of existing management to the business.

  Earn-outs are particularly common in service businesses where there are few tangible assets. However, they frequently lead to messy negotiations and, if definitions of future profits are not watertight, may end up in dispute. The vendors will usually continue to provide most of the senior management during the earn-out period, but operating procedures for the newly acquired business will need to be agreed in detail between the two parties.

- **How the business will be managed**

  As above, where the acquirer needs continuity of management, an earn-out may help to achieve this. Otherwise a commitment should be obtained from directors to stay with the business for an agreed period.

- **Warranties and conditions**

  Warranties may be required if profits fall significantly short of the vendor's projections.

- **Price**

  Initial negotiations will allow a broad price range to be agreed. The process of establishing the value of a business for sale is considered in more detail below.

The vendor will want to limit the time involved in this process in order to push the purchaser speedily to the Letter of Intent stage.

Agreeing an earn-out

Candine ApS was a small cleaning company trading profitably in Copenhagen. Blue Line A/S had a strong presence in Denmark, but wanted to expand. Initial negotiations set a cashflow valuation of €2 million on Candine.

Due diligence revealed that 38% of Candine's revenue came from cleaning contracts with a number of education authorities. The further delegation of school budgets meant that individual schools would now be putting out cleaning contracts, threatening a large chunk of Candine's income.

The final deal kept to the €2 million valuation but deferred €665,557 of the consideration for 14 months and the balance for a further year, while agreeing that, should profits be increased by 10% or more, a further €166,390 would be payable at the end of the earn-out period.

Letter of Intent

The negotiation of the Letter of Intent

The Letter of Intent represents the first step of a negotiation. In fact, in the acquisition context, the Letter of Intent is the initial document where the parties expose and identify the reciprocal positions and the basic intent and the purpose of the discussion had on the conceivable business issues and the key points of a negotiation.

According to the more acceptable legal points of view, the Letter of Intent is a pre-contractual written deed that defines the preliminary understandings of the parties and engages them in contractual negotiations. In other words this instrument identifies the terms of the transactions and exposes the structure of the business, or part of it, to be negotiated.

In most cases the Letter of Intent stresses the preconditions of the negotiation, such as price, peculiar aspects of the transaction and terms for the completion of the due diligence.

The Letter of Intent is generally used and recommended since the document may contain certain binding obligations and provisions that clear the condition for closing the deal. The Letter, usually, imposes a binding obligations with respect to the confidentiality, the charge of the expenses of the "due diligence" and the period of time of exclusivity.

The negotiation of the Letter of Intent is also considered a propaedeutical issue for clear the acknowledgement of the business to understand the real intention and the good faith of the parties and to acquire the basic terms of the transaction.

Furthermore, the document can be used by the parties during the final negotiations and to recall the initial positions and avoid misunderstanding in the spirit of the transactions.

The meeting to negotiate the Letter of Intent could make or break the deal.

Ideally a team leader should be chosen to head the negotiations. This could be the vendor's best negotiator or a professional advisor. It may be advisable to let the most senior team member sit in the background to intervene if necessary.

A pre-meeting should establish roles and tactics. The meeting itself needs to be conducted in a calm and businesslike fashion, with a measured approach and an emphasis on listening. Letter of Intent meetings are often portrayed as pits of conflict, but this is to be avoided if both sides wish to reach a successful deal.

The first part of the meeting will involve both parties agreeing and combining their draft agendas. The major agenda items will be:

- settlement of outstanding issues from the last meeting
- confirmation of assets or the business to be purchased
- personal asset purchases
- asset leases
- pension funds

- personal guarantees
- warranties and conditions
- service contracts for directors
- earn-outs
- timetable
- price.

The settlement of price comes last, as it can only be fairly agreed once the other agenda items have been dealt with.

Where the deal involves existing shareholders buying out other shareholders or one family member buying out another one there may also be consideration of so-called non-embarrassment clauses. These are most likely in a sale involving a medium-sized or large family business. These clauses seek to protect the vendor from the embarrassment of selling at too low a price, only for the acquiring family member to quickly sell the business on at an increased price. The non-embarrassment clause gives the original vendor a right to a share in the uplift the increased sale proceeds resulting from any onward sale within an agreed time scale.

The timetable needs to be approached in some detail. A written and structured timetable allows both sides to identify where slippage is occurring as the sale proceeds. Among other matters it must include:

- the date when Letter of Intent will be signed - ideally within a day or two of the drafting meeting

- when due diligence will take place and when reports will be made to the acquirer. This will need to be done with discretion, otherwise the staff will realise that disposal is imminent

- when the draft legal agreement will be received by the vendor from the purchaser and when a response will be made

- when the disclosure letter will be received. This flushes out information that may otherwise be held back by vendors, such as violated warranties. Very broad sweeping clauses may be used by a vendor to undermine clauses in the agreement and care should be taken to reject such clauses. The acquirer will have to accept or reject the statements in the letter

- when formal board approval will be given for the acquisition: otherwise a floating board meeting may be used to try and force in a last minute reduction of the offer

- when the legal documentation will be finalised

- the date of legal completion.

Usually, the outstanding points in a sale and purchase agreement are best dealt with at a one-off meeting at which both the principals and their advisers are present. This minimises delay by lawyers and obstinate vendors or purchasers. Unless there are particularly significant issues outstanding, the prospect of an all night meeting can focus minds towards an efficient and reasonable agreement.

Due diligence

Once the Letter of Intent has been signed, due diligence tests the strength of the understandings on which an offer is made.

The process will involve a highly detailed check on any matter that might impinge on the value of an offer and the success of the business after acquisition. Finance, tax and legal issues are particularly important and may require specialist advice, although commercial issues need to be examined as an equal priority. For example, if the business being acquired claims to have a certain market share, the acquirer should not simply accept such assertions to be true. Nor should the acquirer accept claims that the business provides the best service in the local market. Market research should be conducted to test such claims, if they are considered vital to the acquisition rationale or the business valuation.

The due diligence process would typically include verification of freehold property ownership, leaseholds, conditions applicable to outstanding liabilities, rights to intellectual property and material contracts. While a contract may contain a series of protective warranties, it is far easier for the acquirer to identify a problem at the due diligence stage rather than having to sue after the event.

The due diligence is usually managed by the acquirer's solicitors and auditors. Both the acquirer and the auditors need to be happy that they are competent to engage in this process.

Information may be requested from the vendor in the form of an extensive questionnaire. In order to make the due diligence process flow as smoothly as possible, the vendor can prepare much of the information in advance, ensuring that all records are complete and that there are no missing documents. Having to obtain copies of contracts or royalty agreements from third parties once the due diligence is underway can be highly time-consuming.

The acquisition agreement

In principle, the acquisition agreement is prepared by both parties. This is followed by a cross-examination procedure by the respective lawyers.

In practice both parties have a significant interest in preparing the drafting of the agreement. It is a relevant safeguard that the initial framework of the agreement is regulated in the correct sense of the discussions.

In this crucial aspect of the business negotiation it is important that the vendor tries to have the control of every draft the acquisition agreement.

The agreement details understandings of both parties about the transaction and must achieve the following objective. First of all, it regulates the structure and terms of the negotiation and discloses the main legal and financial aspect of the business being acquired. Secondly, the agreement provides the paces to complete the transaction and the obligations of both parties.

Since the acquisition agreement is a legally binding deed, it normally governs what happens in case a party fails to execute any of the terms of the transaction. This is extremely important to avoid post-deal litigation. Consequently, the representation and warranties made by the vendor is a very important section of a typical acquisition agreement.

In other words parties have to find in the negotiated agreement all the substantial aspects of the transaction.

Completing the sale

It is clear that there are effectively two stages to completing the sale or purchase transaction (letter of intent):

- an initial investigation in which both the seller and buyer size each other up and decide if they want to proceed further; and
- the due diligence, in which the acquirer formally examines the target in detail to ensure it knows fully what it is taking on.

5. MANAGEMENT BUY-OUTS AND BUY-INS

Management buy-outs (MBOs) are increasingly common and, together with buy-ins (MBIs), represent the most frequent application of venture capital.

MBOs

An MBO has certain attractions. The management team will clearly have an intimate knowledge of the business. This means that, once Heads of Agreement have been signed, an MBO has less risk of failure than a sale to an external buyer; the management team is unlikely to come across any information it did not already know about that could put it off completing the deal.

Some family business owners are also attracted by the idea that they are giving an opportunity to continue the business to people already committed to it, and with whom the owner has built up a working relationship. On an emotional level they may feel they are passing the business on to known and trusted hands, rather than an unfamiliar third party.

However, while an MBO has its attractions, several factors need to be considered:

- is the business suitable for a buy-out?
- does the buy-out team have the ability, financial resources and commitment?
- is the deal structure and price acceptable to both sides?
- can the deal be completed to an acceptable timetable?

A suitable business for an MBO must be commercially viable, run by an able management team which offers potential for growth, supported by an attainable business plan.

The management team must demonstrate its commitment and will need to persuade a venture capital firm to back the deal. To do this they must demonstrate that they have the skills to add value to the business and develop it further. They must also consider what exit routes might be open to the backer, usually in three to five years' time.

In some cases vendors are prepared to give a small discount (no more than 5%) in the price they accept from a management team compared to the price required from an external buyer. This reflects the greater likelihood, in most cases, of the MBO deal completing. However, price negotiations should always take into consideration the number of such bidders and the strength of competition between them.

In terms of achieving an MBO, vendors and management teams generally underestimate the time it will take to complete the deal. Legal completion may take up to six months. Vendors should also be aware of the danger that the management team become distracted from the task of running the business. If performance slips, venture capital backers may try to reduce the price paid.

Owners should also be aware that some external companies will be put off from making a bid to buy the business if they know that the management team is itself trying to pull off an MBO. This is because they suspect the management team may have better knowledge to be able to complete the deal at an appropriate price.

Managing an MBO - an example

The owner of a family printing business wanted to retire and was keen to sell to his existing management team, since he had worked with many of them for several years. He was hoping to realise €16.6m from the sale. The business had been performing consistently for a number of years and the management team believed there were opportunities for its growth and development.

However, the owner's advisers suggested sounding out a few other potential buyers to stimulate competition. A number of potential acquirers were contacted, and several of these expressed interest in the opportunity.

Meanwhile, the management team divided their time between running the business and developing their own business plan and acquisition proposal. Their venture capital backer suggested an offer price of €15.8m.

The owner hesitated, waiting to see if the third parties could do substantially better. Unfortunately, these companies discovered that the management team were also bidding and were reluctant to compete against them, believing their insider knowledge gave them too great an advantage. Despite waiting three months, no offers were made by any of the external companies.

The management team's backer then reduced its offer to €15m, as turnover had stalled slightly during the intervening period while the owner was distracted by meetings with the potential external bidders. The owner decided to accept the offer, and the MBO completed four months later.

MBIs and BIMBOs

Sometimes the existing management team may not be interested in buying the business or may not have sufficient expertise. This could well be the case in a family business where the owner was closely involved in running the operation.

In such cases a management buy-in may be appropriate, with external management personnel joining the business and taking a stake in its equity at the same time. Venture capital firms often have such individuals on their books looking for suitable investment and management opportunities.

Alternatively, the deal may involve a combination of an MBO and an MBI – where the existing management team buy into the business, but their skills are reinforced by a new joiner who buys in. A deal like this is called a BIMBO (buy-in management buy-out). It has several advantages in that it makes use of the existing management's knowledge of the business, while ensuring that they have all the skills and experience they need to realise their plans for growing the business in future. BIMBOs may be somewhat more complex to put together than a simple MBO or MBI, but they can provide a useful solution where there are obvious gaps in existing management skills.

Stock options - a Belgian example

Stock options are the possibilities given to employees and staff to gain options which can be exchanged into shares of the company after a certain period.

Belgian tax law gives the opportunity to deal as a dividend at the end of the year with the personnel. Employees can receive almost tax-free options on shares of the company they are working for. The shares can also be of a company of the same group of companies where they are working for.

These options must have a defined term. Within the stated period options can be transformed into shares against a price, stipulated at the moment of the allocation of the stock options.

In the balance sheet as per 31/12/2001 all staff receives for free stock options. The exchanging period is from 3 years to maximum 5 years; and the exchanging price will be €100,00 at that time.

After 3 years the shares of the company have a value of €140,00. The staff will have interest in changing the options into shares for a price of €100,00 because they receive a value of €140,00 by paying €100,00, so they can gain €40,00 without any fiscal consequence.

Although it is uncertain that price will go up in the period stipulated in the stock option plan and therefore employees are not always interested in this situation.

At least can be said that the possibilities of stock option plans are stimulated in fiscal laws in Belgium to improve the interest of the personnel in the companies where they are working.

6. THE ROLE OF THE ADVISOR

For members of a family business the sale of the business is likely to be the key to their future. It is important therefore that they obtain as much help and support to ensure that the sale is a success. This will include employing external advisors. It is likely that a professional accountant will be able provide the most important advise in this context. This because the professional accountants' training should provide the understanding and expertise to support the members of the family at all stages of the process of selling the business.

It is likely that all family businesses will employ an external accountant for a varying range of services, for example, taxation and audit. When the members of the family business begin to consider options for disposal of the business it is important that they consult their external accountant. The accountant should be able to advise about the various options. The use of an accountant at this early stage in the decision to dispose of the business is critical; for example, tax may play an important part in that decision and it is the accountant that will be the appropriate advisor to assess its implications on the decision. If the option of selling the business is established as the favoured outcome the external accountant should also play an important role in providing advise.

In the identification of potential buyers the accountant can play an important role. From the professional accountants' local knowledge of his other clients and networking with other accountants and other business advisors a potential buyer for his client's business may be identified. It was also discussed that if the vendor has identified a potential buyer it would be wise to use the accountant to make the first approach because they would be seen to be more independent.

The vendor is likely to want use the accountant for valuing the business as this is a complex process. There are also a number of functions that the accountant can perform in dressing the business for selling. In this context, it is very important that the quality of the financial information is high this will enhance the chances of a quicker sale and speed up the time of the process of due diligence.

Accountants in practice, as mentioned above, will invariable be in a local network of business advisors such as lawyers and bankers and thereby have knowledge of the individual attributes and expertise of particular firms. The accountant therefore is in a good position to identify any other advisors that will be required by the vendor in the process of selling the business.

Whilst the use of advisors may be seen by the vendor as expensive in terms of professional charges for their services, vendors should benefit from an improved contract conditions and sales price, as well as reduced stress. An error caused through a lack of expertise in the process may be very costly to the vendor and could also result in a failure to secure a sale. The vendor by using the appropriate advisor should also be less distracted from the day-to-day running of the business.

APPENDIX

OTHER READING

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