GUIDE TO BUYING A BUSINESS

CORPORATE FINANCE

M3 Corporate Finance

M3 Corporate Finance is an independent corporate finance house focused exclusively on mid-market transactions.

M3 offers specialist corporate finance advice to shareholders and managers / directors of companies and private equity houses concerning:

- Exit strategy and company sales
- Management Buy Outs
- Management Buy Ins
- Corporate acquisitions
- Development & replacement capital
- Corporate divestments and restructuring
- Recapitalisation equity release (“Cash Out”)
- Vendor roll-over

Our services are always led by an owner partner guaranteeing our commitment to your deal.

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Further information can be found at the back of this guide.

INTRODUCTION

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

Acquiring another business is a common way to expand your existing business. However, many acquisitions do not realise the benefits that were anticipated and can have a detrimental impact on the existing business. So acquire with caution.

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 DO IT?

There are many good reasons for growing your existing business through acquisition. 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. These products or services may be available immediately and will 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 you.
- *Reducing your costs and overheads* through a shared overhead base (e.g. property, finance, marketing etc) plus increased purchasing power resulting in lower costs.
- *Obtaining quality staff or additional skills*, knowledge of your industry or sector and other business intelligence. For instance, a business with good management and process systems will be useful to a buyer who wants to improve their own and acquisition maybe easier than trying to recruit.
- *Accessing valuable assets for new development.* Better production or distribution facilities are often less expensive to buy than to build. There is also the opportunity to get better utilisation from them.
- *Organic growth*, i.e. the existing business plan for 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 defensive acquisitions.

What can go wrong?

The extent and quality of the planning and research you do before an acquisition will have a major impact 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 and a mood of uncertainty.

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) being 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 for you to consider include:

- 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 markets, companies, products and services you need. Once you have developed the target profile, you can:

- Consider firms you sell to, or buy from, already. Most completed acquisitions in the UK occur between companies with some existing relationship (customers, suppliers or competitors). Vendors rule out many potential buyers at an early stage, for a variety of reasons, and you should not rely on the grapevine to position your business for 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.

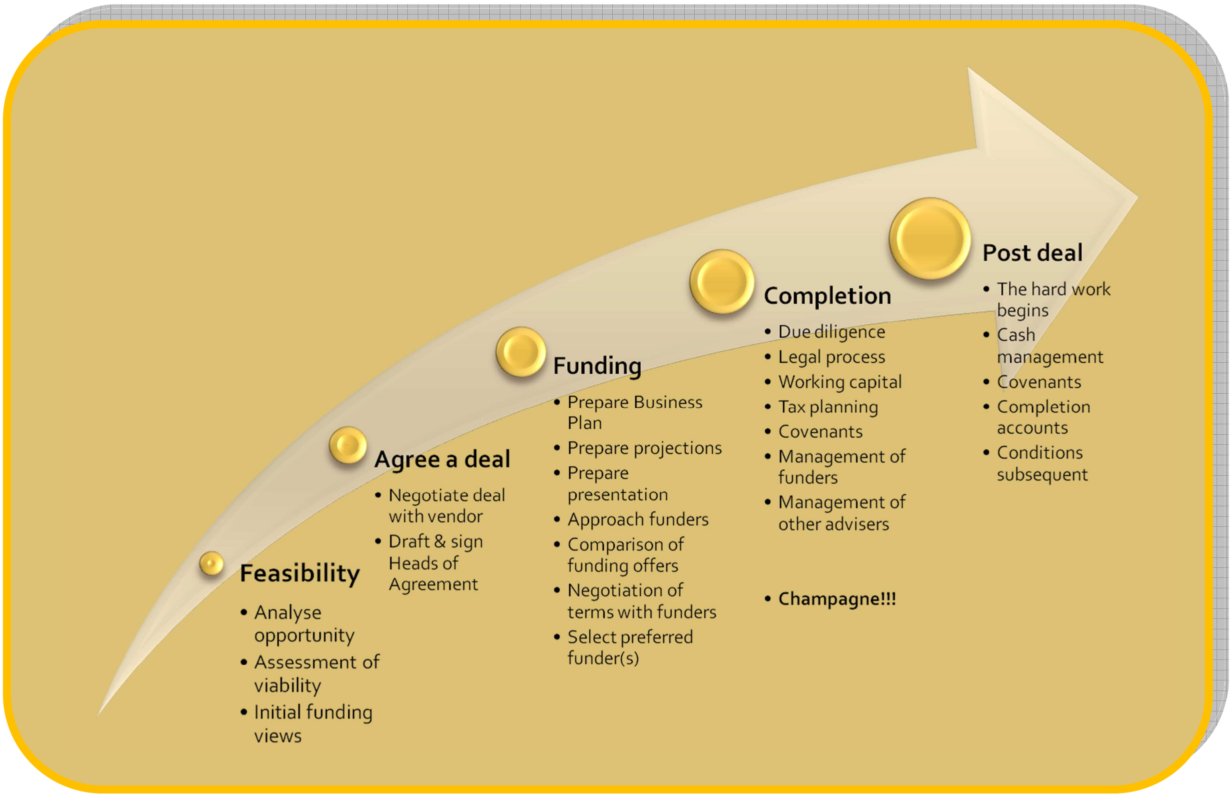
- Encourage senior staff to use their networks to gather information about likely prospects in your sector.

- The business press can highlight opportunities either by allowing you to invite approaches by potential vendors, 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.

- Circulating acquisition criteria to corporate finance houses and investment banks is a positive, but unfocused attempt to hear of opportunities. Whilst deal flow will improve, you are likely to receive details of companies with only a passing resemblance to your preferred profile, and you will not hear of them on an exclusive basis.

- Management research suggests that more successful acquisitions are achieved when a purchaser has invested time and effort in a dedicated 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 and hard copy 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. Financial advisers will assist companies with this research, and they should reduce the initial trawl down to no more than a dozen or so companies who most accurately fit the acquisition criteria of the purchaser.

THE ACQUISITION PROCESS



APPROACHING A TARGET

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

There are three common ownership structures for unquoted companies in the UK – the owner-managers, the venture capitalist / management team combination, and the 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 venture capitalist or the group managing director.

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 then following up with a telephone call can be productive. The ability to interact with the decision maker and explain the rationale for the approach is unmatched, and is to be recommended. 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 the 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 want to avoid auctions, particularly those conducted by professional advisers, where prices can be forced up by the principle of supply and demand.

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

- Key drivers to 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 and contrast all information received from the target, with that available from independent third parties. This is most relevant in respect of market conditions and future prospects, and will be revisited later.

In addition you should attempt to 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.

As well as having to have demonstrated your credibility as a buyer it is likely that the target will require you to sign a "Confidentiality Letter" or "Non-disclosure Agreement". As you are likely to divulge information about your own business 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 the trust between the two parties and the likelihood of a deal increase.

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.

VALUATION

Unlike public companies, private companies do not (usually) have price tags on them. You can spend many hours understanding business valuation methodologies for formally valuing a target company. However, the value of any company is that which a purchaser is willing and able to pay.

In determining the value that should be paid, a purchaser should have a view of the long-term addition to shareholder value that the acquisition will bring, and the costs of the acquisition itself (transaction costs, financing costs and integration costs).

The long-term shareholder value increase should reflect the increase in maintainable earnings of the existing business plus the maintainable earnings of the target after any synergies.

Any valuation based on future earnings should be sensitised to reflect the uncertainties of financial forecasts, particularly in the longer term.

The skill, from the purchaser's perspective, in negotiating the value to be paid is not to give away the benefits that the purchaser brings to the combined entity. Those benefits should be for the gain of the purchaser's shareholders, not the target's.

Why business valuation methodologies are flawed

Despite their ongoing use, valuation methods are so subjective that it is impossible to endorse them as foolproof. For example, there is no way that you can use other like businesses as a realistic barometer because no two businesses are the same. Furthermore, the financials being used are historical data and since the past is over and done with how can you accurately use the past to predict the future? Insofar as looking at net assets, unless you fully validate the usefulness of the assets this too becomes subjective and in reality they are usually being acquired not for their own value but for the future profits they can help generate. Notwithstanding the inaccuracies of these methods, you should use a factor of each to value a business from every angle possible and then balance it all with what the value of the business is to you.

No two businesses are alike

Although valuation methods will use other like businesses for comparative purposes do not allow you to be lulled into believing that any two businesses are really alike. You may want to explore these situations to see what businesses may have sold for, but you are guaranteed that there are always enough differences to render these comparisons inaccurate.

Good versus cheap

If your intentions are to find a cheap business you must be prepared to never find one or to deal with one that may never turn into what you had hoped that it would. It’s akin to buying a cheap used car versus a good used car that you have checked over extensively. Yes, there is a chance that you will get lucky and get one that runs relatively trouble free for a long time, but the odds are that you will get one that requires ongoing maintenance. If you want to dramatically improve your chances for business success then look for a good business that can become great.

STRUCTURING AND 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. Do not rely on the vendor's figures.
- 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 low net assets.
- Relies on one or two major customers (or contracts, or suppliers, or key employees).
- Is currently unprofitable, or has a chequered history.

Writing an offer

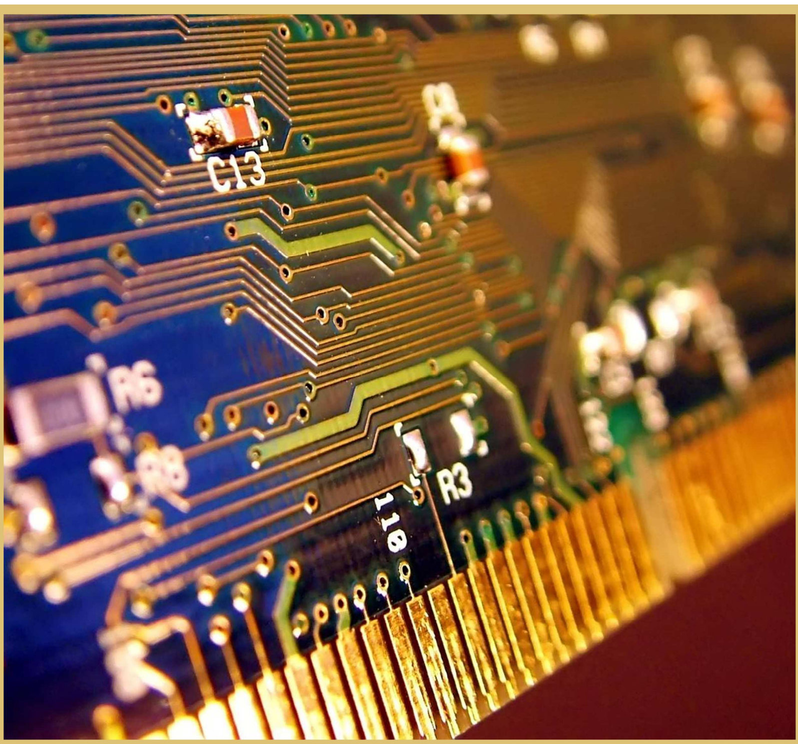
When formalising your offer, always put in writing but head it "Subject to Contract". The vendor may have laid out the matters they want you to cover but even if not cover areas such as:

- Your price.
- When the consideration is to be paid and in what form (cash, 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.

If an offer can be agreed (often after much negotiation) then it is worthwhile detailing what has been agreed 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 what has already been agreed is laid out in the Heads. The Heads will typically cover a period of exclusivity as well to enable the transaction to be completed.

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.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DUE DILIGENCE AND CONCLUDING THE DEAL

Due diligence

Due diligence has become an ever more important phase of a transaction. Due diligence investigations are now covering the following areas:

- Financial
- Commercial
- Technical / operational
- Legal
- Taxation
- Environmental
- Pensions
- Insurance

Not every deal requires every aspect, and some elements can be carried out by the purchaser themselves. Other areas can be carried out by external advisers as required. If external funding is required then the funders are more likely to want more of the work 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 venture capitalist) it is very 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 they are debt providers 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 the due diligence then make the vendor aware as soon as possible. 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 fees.

Why will we need tax advice?

Expert advice is needed before the acquisition is legally completed in order to ensure the maximum financial benefit for the shareholders after paying income and capital gains tax and also to ensure the company has the necessary protection in respect of any tax irregularities that subsequently come to light. Issues that need to be addressed are:

- The structure of the transaction and the requirements for any tax clearances;
- VAT registration for the new company and advice on the recoverability in relation to deal costs;
- Opportunities to minimise capital gains tax and inheritance tax liabilities on future gains;
- Tax indemnities from the vendor; and
- Payment of stamp duty.

Why do we need to appoint a corporate finance adviser?

A corporate finance adviser should be appointed right at the start and will be fully involved in all aspects of the transaction until completion including helping you find appropriate targets. 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 where a corporate finance adviser will be involved are:

- Finding and approaching targets;
- Assessing the feasibility of the acquisition;
- Valuing the business;
- 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 the management team to other advisers such as lawyers and tax advisers etc;
- Monitoring deal costs; and
- Project managing the entire transaction through to completion.

AFTER THE DEAL

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

There is a lot do over the next few weeks – 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 USE M3?

Your adviser needs to be an experienced corporate finance adviser with wide experience in advising corporates on buying businesses with a proven record.

M3 differentiators	*So what...?*
Owner managed business	Its more personal We understand deals as Principal & Adviser Entrepreneurial in outlook
Our people	Partner led advice throughout the deal Experienced team who know how to acquire & sell businesses & understand the dynamics of transactions Mix of backgrounds from accountancy, banking, private equity & industry
Track record	Regular contact with funders Activity creates experience Vast pool of accessible knowledge
Creative & innovative	Creative deal structures that work for our clients We get the job done
Independent & focused	This is all we do – no conflicts of interest Team hungry to deliver We focus on our deals
Excellence & commitment	We strive for excellence in our work Strong research capabilities Committed to client satisfaction, standards & performance

CONTACT US

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M3 Corporate Finance – our Owner Partners

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- Gary originally trained as a Chartered Accountant with two periods working in industry.
- Having spent the last 16 years in Lead Advisory and Venture Capital markets, including five years as a Venture Capitalist, Gary has valuable experience in raising finance for businesses, working with management teams on MBO's and MBI's, as well as buying and selling companies from £1m to £100m+ and in numerous sectors both as an adviser and a principal.

Matt Oliver

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- Matt provides lead advisory support to corporate clients & management teams on the complete range of corporate finance activities.
- He has developed particular expertise advising management on both Buy Out and Buy In transactions. In previous roles he has advised on larger international transactions & helped secure growth equity finance, both as adviser and as part of a management team.
- In addition, Matt held a number of senior financial positions globally.
- Matt qualified as a Chartered Accountant with Arthur Andersen.