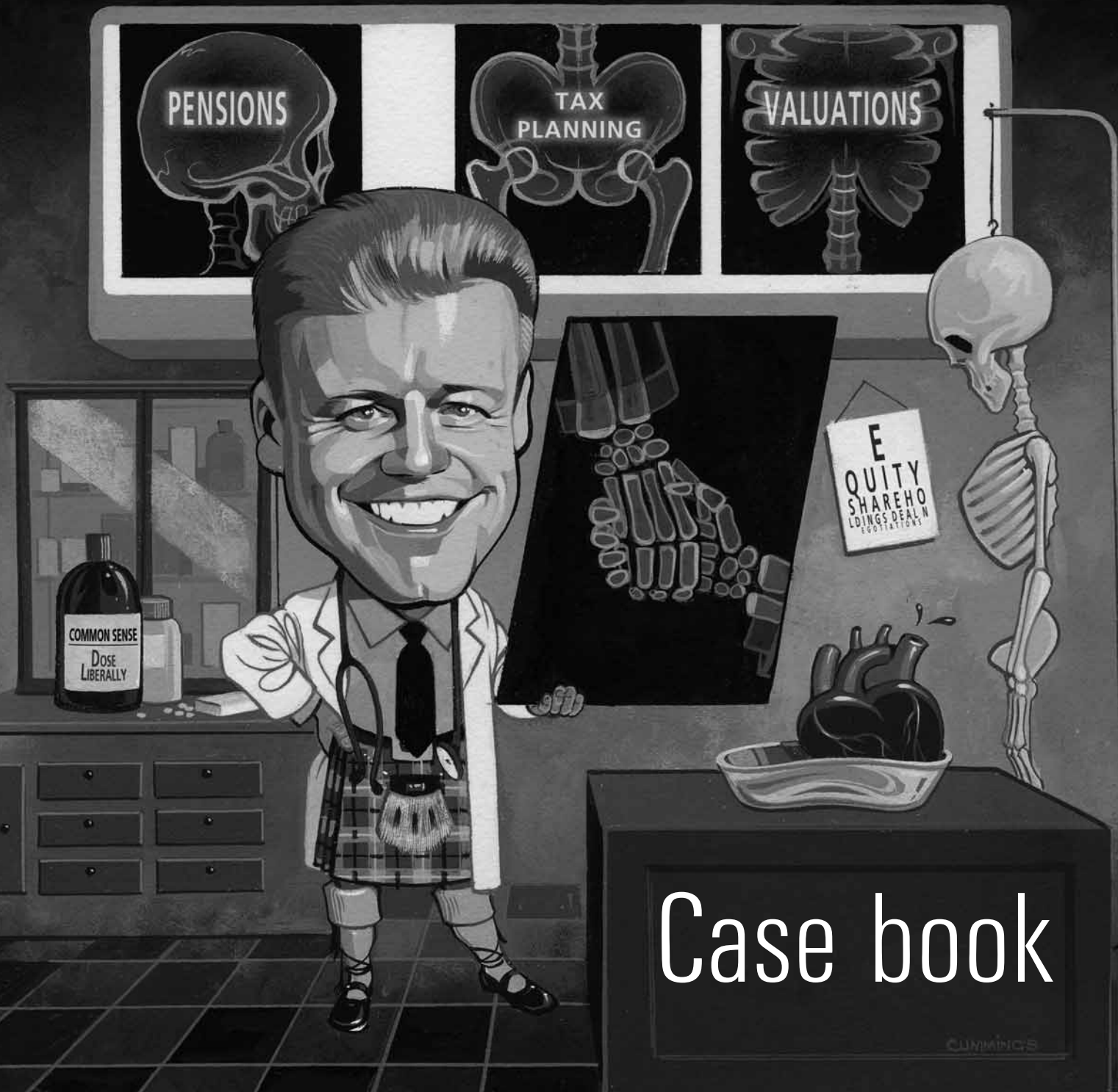


# Dr McDeal



**Doctor McDeal's Case book** brings together a collection of articles on corporate finance issues published in Livingstone Guarantee's **Acquirer** magazine since 2001.

Livingstone Guarantee is the UK's leading investment banking boutique focused on unquoted deals with values of between £5 million and £100 million. Our core expertise lies in advising successful entrepreneurs, private equity investors and major groups on the sale and acquisition of companies, and management teams on raising funds to acquire the businesses that they work in.

The defining feature of our advice is that it is based on the experience of our seasoned deal leaders: the Livingstone Guarantee team has advised on the purchase or sale of over 350 businesses since 1995. Many of our deals are cross-border, based upon the strength of our research team in London and the reach of Global M&A, the international partnership of investment banking boutiques that we co-founded in 1993.

We hope that you find the practical advice contained in the following articles of help in your everyday pursuit of shareholder value. Many company owners and management teams have only one opportunity in their careers to turn their hard work into hard cash, or to secure the ownership of a business for themselves. These articles are intended to give you a head start.

If you have questions arising out of any of the articles or in respect of a specific transaction, you are warmly welcomed to contact any member of the Livingstone Guarantee team in strictest confidence on +(44) 207 484 4700 or Doctor McDeal himself, partner Gordon Blair, on +(44) 207 484 4705 or at [gordon.blair@livguarantee.com](mailto:gordon.blair@livguarantee.com).

*Livingstone Guarantee*

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Every new private company sale process has an “Antiques Road Show moment”, when successful shareholders ask: “What is my business worth then?” Doctor McDeal tackles this thorny topic with surgical precision.

**Is there a “right” way to value a business? Or is it all just guesswork?**

Valuation experts tie themselves in knots when they champion the latest “definitive” valuation technique. What may be right for one kind of business in a specific sector at a particular point in time may be completely wrong for another.

Profit has for many years been the most popular measure of value. By applying a multiple to a company’s sustainable profitability, you can derive a capital value (ie “How many years’ profit am I willing to pay for this target?”). In the last 10 years, the market has favoured a broad spectrum of definitions of profit: earnings (profit after tax), EBIT (earnings before interest and tax) and EBITDA (earnings before interest, tax depreciation and amortisation).

The preferred definition at the moment appears to be EBIT. EBIT multiples can range from as little as 3.5 times for a small contracting business to five or six times for a successful product based manufacturing business, to eight or nine times for a higher growth technology or business services company. Applying the multiple to EBIT gives you a “gross” valuation, out of which you must deduct any debt and onto which you should add any cash on the balance sheet.

**So what factors influence the value of my company?**

There is no 100 per cent accurate valuation technique. Large groups and private equity houses prefer to value companies based on cash flow over the period of ownership or investment. Particular industries develop their own “back of the envelope” valuations, which can be quite telling. Ultimately, the market is the only true measure.

There is a correlation between higher multiples and businesses

with high growth, critical mass, good customer spread and strong trade or consumer brands. Businesses that are smaller, heavily dependent on an owner or a few customers and have “lumpy” project based fees tend to attract lower EBIT multiples as a direct reflection of their “riskier” profile.

**So what is my business really worth then?**

Conventional wisdom has it that it’s worth whatever a

has no current cash value is never easy – but an unsuccessful sale or IPO is time consuming, distracting and costly.

**OK, forget the sale, it’s a lifestyle business – then what?**

A common obstacle to doing deals arises when the owners’ perception of value rests solely on how big a lump sum they require to generate the same income as they did when they owned the business.

“Valuation is an art not a science. There is only one right answer: let the market tell you how much your business is worth”

purchaser’s prepared to pay for it. Wrong! A company is not what a single purchaser thinks it’s worth but what several purchasers think, each having the same information on the business and fully aware that it’s in competition with other bidders to acquire the asset.

It’s dangerous for any adviser to proffer a valuation based on a business’ bare numbers, without having a good grasp of purchaser or investor appetite. If there is no interest among purchasers, the business will not be sold and therefore has no cash value at present. If so, groom the business for several years or concentrate on income over capital. Telling an entrepreneur close to retirement that their business

A relatively small business with sales of £5m and profit before tax of £600,000 can generate the shareholders an income of £500,000 each year. However, the “market” value of the business may be £3.3m – reduced to £3m of “net” proceeds after capital gains tax.

In the current low interest rate environment, that cash may generate income of as little as £150,000 per annum. But the shareholders need £500,000, which means they need to achieve a cash value closer to £10m. Not a chance!

If the shareholders’ focus is on maximising income rather than de-risking and extracting a capital sum, they shouldn’t be considering a sale.

**How about a good old fashioned MBO valuation?**

The valuation placed by a private equity player on your business will be derived in a very different way to a trade buyer.

Trade purchasers will value a company on the basis of quantifying the synergistic or strategic benefits of making the acquisition and, frankly, how badly they want to do the deal.

Financial investors have no synergies or strategic benefits to extract. The amount that they can afford to pay for your business is linked to how much debt and equity finance your business can afford to support going forward.

This means that you rarely see the variances in valuation among competing private equity houses as you do with competing trade purchasers.

Some investors will gear the business up more aggressively than others or will be willing to see a lower return on their equity investment. Ultimately, however, the potential valuation will be capped by the strength of your business’ cash flow and its balance sheet. That’s not to say that private equity investors may not pay the highest price for your business.

**No easy answers, are there?**

Valuation is an art not a science. There is only one right answer: let the market tell you how much your business is worth. But do talk to the experts before you push the button on a sale or IPO to avoid disappointment. Valuation is very subjective: beauty truly is in the eye of the beholder – so make sure that your business is a stunner!

Creating a competitive tension between buyers can dramatically increase the value of your business, so always be wary of “sweetheart” deals, where you negotiate with a single purchaser.





#### Dear doctor

I am about to enter into negotiations with a potential purchaser of my business. How should I prepare?

#### Dear “unsuspecting victim”

First, be quite clear on the strengths and weaknesses of your business. This will enable you to “sell the sizzle” convincingly and tackle the more difficult questions when they arise. Secondly, research valuations and deal structures for recent transactions involving similar businesses. Work out what makes businesses more or less attractive in your sector. Be familiar with the deals concluded recently by your potential purchaser and understand the rationale for those transactions. Finally, be clear why the potential purchaser ought to have an interest in you. Where synergy savings or cross-selling opportunities are involved, understand them completely. Estimate the possible advantages of bringing the two businesses together. This will aid in negotiations by allowing you to focus on the upside and in subsequent due diligence.

#### Dear doctor

The other side is pressuring me to give an indication of the price I want. Should I?

#### Dear “keeping it close to your chest”

It is generally not in any vendor’s interest to give a premature

You’re ready to sell your business, but to conclude the best deal, you will need to hone your negotiating skills. Livingstone Guarantee’s deal doctor, **Gordon Blair**, shares tips on how to haggle.

indication of value. To do so risks placing a ceiling upon your own price aspirations, and it may be taken as a sign of weakness. It is usually better to insist that potential purchasers value the business on the basis of what it is worth to them and to make their offer without any guidance from you. You can then assess the strength of your position before making a response. If a potential purchaser is genuinely serious, they will be prepared to go first on price. You may be pleasantly surprised at the level of offers. Having received offers, if the level of interest is weak, it may then be appropriate to set an asking price, as this will enable you to assess quickly your prospects of a successful outcome. If the interest is strong, request further improvements before revealing your hand.

#### Dear doctor

I have received an approach. Should I restrict my discussions to one party or widen the field?

#### Dear “keeping your options open”

Where you are able to generate competitive interest for an attractive business, the best offer may well be 50 per cent better than the lowest offer, and often even more. If you are dealing with only one potential purchaser, you may find it hard to assess whether their offer is the best you can achieve. You will be less likely to have a fall-back purchaser in the event that subsequent negotiations prove unsatisfactory.

Discussions with one party have a greater chance of success when both parties know each other well. In this case, the advantages of bringing the businesses together can be assessed by both sides with greater certainty. However, before committing yourself to this route, make sure that these advantages are

achievable and that they have been reflected in an offer for the business that is markedly better than what would be available from a purchaser with less clear-cut advantages.

#### Dear doctor

I have had preliminary discussions with a number of purchasers. One of them has offered a good price but wants immediate exclusivity. What should I do?

#### Dear “afraid of commitment”

As a general rule, it is better to resist exclusivity until all the major commercial aspects of the deal have been agreed. The headline price will be the most important aspect of this, but you should also consider any deferred or contingent aspect to the deal – and other matters such as property complications or restrictions placed on the vendor after the deal has been concluded.

Consider whether the potential purchaser knows the business well enough to follow through with an apparently attractive offer. Your negotiating position is likely to reduce once exclusivity has been granted, so resolve these issues early on. Be especially wary of purchasers who make an attractive offer in order to gain exclusivity with the intention of using due diligence to reduce the price later.

#### Dear doctor

I am well advanced in negotiations with a preferred purchaser, but have recently received bad news concerning an important customer. What should I do?

#### Dear “struggling with the truth”

Most purchasers take their due diligence seriously, so expect them to find out sooner or later. They may also seek some form of warranty cover that effectively forces you to make a disclosure. It is generally

better to bring this information to their attention on your own initiative. Do not do so, however, until you are sure of its extent and effect. Understand why things went wrong and what can be done to rectify or prevent recurrence. Calculate the effect it will have on your business in detail and present the outcome to the potential purchaser in as positive a light as possible. Require them to give their definitive response as soon as possible. Do not allow them to store this issue for a later negotiation.

#### Dear doctor

How do I protect myself from the deal being renegotiated at the eleventh hour?

#### Dear “no last-minute tricks”

Always stay on good terms with the bidder who came in second – you never know when you might need them. Be careful not to leave bad news to be discovered when the purchaser has gone into exclusivity – they may well be tempted to exploit it. Ensure that when you sign heads of agreement there are very few issues remaining to be agreed. Make clear to the purchaser that there are only two possible outcomes: that they are happy with the outcome of their due diligence and complete the deal as agreed, or they decide not to do the deal at all. Do not allow re-negotiation of the deal to become a third option. Give yourself the right to terminate exclusivity if at any point the purchaser cannot confirm their intention to complete the deal on the agreed terms. Limit the period between signing heads and completion – you won’t be given credit for good news, so minimise the opportunity for bad news.

For more advice, make an appointment with Gordon Blair on 020 7484 4705 or visit [www.livguarantee.com](http://www.livguarantee.com)



### Dear doctor

Back to basics here, I'm afraid doc. What exactly is an earn-out?

### Dear definition seeker

An earn-out anticipates the sale of 100 per cent of the issued share capital of your company at the point of legal completion. It is a pure contractual commitment by a purchaser to pay further value for your company if you meet agreed performance targets. From the purchaser's perspective, the purpose is to incentivise you to ensure that the acquisition is a success. For you, an earn-out can be an important means of bridging any valuation gap between your price expectation and the price that a purchaser is willing to pay based on your company's financial performance. In many cases, the amount that vendors can achieve under the earn-out can exceed the amount received at completion.

### Dear doctor

So when and in what types of businesses are earn-outs most appropriate?

### Dear scenario planner

Earn-outs make sense when you intend to stay on after the sale and will continue to make a significant contribution to the business. They become more problematic when not all of the vendors are involved in the day-to-day running of the business, for example when the business that is being bought

You want to sell your business and you have heard about earn-outs as a possible option. But you are not sure of the precise implications. Livingstone Guarantee's deal doctor, **Gordon Blair**, explains all...

is partly owned by a private equity house. In such cases, there is frequently a potential conflict between those vendors who want the maximum amount paid on exit and those that are keen to maximise the earn-out. Corporate vendors selling a subsidiary generally have no interest in earn-outs as, once the company has been sold, they cannot influence the achievement of any performance targets.

### Dear doctor

What terms and conditions need to appear? Are there cases where, although possible, an earn-out just won't work?

### Dear doubter

The terms of the earn-out need to be carefully tailored to meet individual circumstances. If the acquired company is to be run largely autonomously post-acquisition, then a profit-based earn-out may be appropriate. If, however, the target company is to be entirely integrated within the business of the acquirer, an earn-out may not be appropriate. If a purchaser wishes to extract immediate synergies from buying a target, the "ring-fencing" of the target's business required as a result of an earn-out can make an earn-out unattractive. In most cases, the existence of an earn-out requires a large degree of shared expectation for the outcome of the transaction between yourself and the purchaser.

### Dear doctor

That all sounds fine and dandy, but how do I protect myself in an earn-out deal?

### Dear cautious one

Before entering into an earn-out, you must understand and endorse the reasons behind the purchaser's wish to make the acquisition and the way in which the two organisations will work together in the future. You should be an important contributor to achieving

those objectives. Measuring the extent to which objectives have been achieved will be fundamental and will need agreement on the accounting policies to be used, the treatment of any management or central charges levied on you, the cost of funding and the availability of resources to pursue business opportunities.

The important principle is that you must be given the freedom to achieve the performance targets for your earn-out. This means that your company must be "ring-fenced" from undue interference by its new parent company for the length of the earn-out period. All of the necessary checks and balances will be dealt with in the share sale agreement.

Corporate governance needs to be agreed beforehand; you want the maximum opportunity to achieve the earn-out, while the acquirer will want the right to protect his investment. Conflicts can arise where the acquirer may want to do something which is in the overall best interests of his enlarged group but which you feel is to his advantage. New business opportunities may well fall into this category. Most vendors will seek to achieve the earn-out within two or three years with interim payments. As earn-outs extend in time, they generally become more uncertain.

### Dear doctor

Let's say I'm not too keen on an earn-out. What are my alternatives?

### Dear "it's wise to keep your options open"

One option is for you to take shares in the acquirer as part of the consideration. This may enable you to benefit from the advantages that the acquirer expects to gain from the acquisition. To be effective in this way, however, the transaction has to be material to the acquirer and you will need considerable

knowledge of – and confidence in – the acquirer's share liquidity, activities and prospects. Another alternative is to convert the earn-out into a royalty agreement. This implies a lower level of involvement in the business after the disposal. In many cases, vendors will join the acquirer on a long-term basis and benefit from salary and bonuses in the normal way. Finally, it may be possible to structure a deal around combining the sale of an initial minority or majority shareholding in the target company with the grant of an option or options to acquire the remaining shares over an agreed period of time based on a negotiated valuation formula.

### Dear doctor

Last, but not least, how should I get paid?

### Dear "get your priorities right"

This is an important technical consideration – how the future earn-out payments are settled under the earn-out. If the earn-out payments are in cash, the Inland Revenue will make its own assessment of the proportion of the earn-out it thinks you will receive and then charge you CGT on the hypothetical gain at the date of the initial sale of 100 per cent of your company. As a result, earn-outs are conventionally structured around the payment of future value in the form of "paper": loan notes or shares to be issued by the purchaser in due course. This enables any capital gain to be rolled into the loan notes or shares, and CGT is only payable at the redemption or sale of those "paper" instruments.

For more advice, make an appointment with Gordon Blair on 020 7484 4705 or visit [www.livguarantee.com](http://www.livguarantee.com)





Most potential purchasers will ask you to give them a period of exclusivity before starting due diligence. But what are the ins and outs? Livingstone Guarantee's resident quack prescribes some strong medicine.

#### So what is exclusivity?

It is a legally binding commitment given by the potential seller of a business to an acquirer not to deal with competing bidders for an agreed period of time. A vendor generally agrees not to: continue any ongoing discussions with rival bidders; solicit or procure, directly or indirectly, competing offers for the business; respond to any unsolicited approaches or offers; or disclose any information about the business to a third party.

#### Why should I give it?

Most purchasers insist that you grant them a period of exclusivity before starting their due diligence investigations into your company. There are two reasons for this. Firstly, they want breathing space to complete the acquisition without worrying about competing bidders. Secondly, due diligence is an expensive exercise, regularly costing purchasers more than £250,000 in fees. This represents a significant risk for the purchaser, so in return it expects a commitment from the seller not to negotiate an alternative deal with rival acquirers.

#### What about a non-refundable deposit?

Buying a business is not like buying a house, where the purchaser typically has to put down a 10 per cent deposit that it may sacrifice if it does not complete the purchase. There are very few examples of acquirers making a non-refundable deposit to secure exclusivity. I can think of only two instances in 300 completed deals where this has been achieved and in both instances the purchaser was a direct competitor of the business being bought. In these cases, the acquirers would have presented a serious threat if, having completed their due diligence, they had then walked away armed with the benefit of a unique and detailed insight into a rival's operations. While on the one hand, 'if you don't ask, you don't get', you need to recognise that it is unlikely you will be able to secure a deposit. Even if you do, the terms of any refund are

likely to be fairly restrictive. For example, if the purchaser's due diligence discovers a material and previously undisclosed problem in the business, they will insist on walking away with their deposit back in their pocket.

#### When should I grant it?

Most experienced purchasers seek exclusivity as early as possible – even before they have made an indicative offer for the business – in order to 'lock out' any competition. But vendors are usually savvy enough to realise that they will draw no advantage from granting exclusivity so early. There is nothing like healthy competition between rival

will all have a bearing. In the glory days of 2001, deals could take as little as four weeks to complete from signing heads of agreement, whereas in the dog days of 2002 the same deal could have taken up to 12 weeks. A reasonable exclusivity period for a 'typical' deal in the current climate might be around six weeks for a trade sale and up to eight weeks for a management buy-out.

#### How should exclusivity be structured?

It is often not appropriate for a seller to grant a simple six-to-eight week exclusivity period. Increasingly, it makes sense for

the heads of agreement say but also what has been agreed in the spirit of the transaction. Sloppily drafted exclusivity clauses may well give a seller some 'wriggle room' to discuss a deal with other purchasers. A frequent oversight is where exclusivity prevents the seller from proactively seeking rival bids but fails to anticipate offers being received 'passively'. If you receive an unsolicited offer while bound by exclusivity the best advice is to either 'park it' until you are legally free to pick up the conversation or, if the new offer is much more attractive, to come clean with your first bidder and seek to lapse exclusivity on the basis that you have decided against selling to it anyway. Whatever the specific terms of the exclusivity clause, there is clearly a moral obligation on a vendor to be above board with their acquirer.

#### What if I breach an exclusivity agreement?

Always talk to your lawyer if there is a risk of your breaching exclusivity, as every exclusivity arrangement is different. Very few clauses specify penalties in the event of a breach, which means that contract law will determine the outcome. Generally, a purchaser will have to demonstrate that it has suffered actual loss as a result of the breach. The loss of the opportunity to acquire the business probably does not count, as a seller is under no obligation to sell to an acquirer until the deal is legally completed. However, the purchaser may have incurred significant professional fees and this is the seller's main financial exposure. The likely cost of reimbursing the purchaser for these fees needs to be balanced against the terms of the rival offer. Needless to say, it is best to avoid the courts and pursue a negotiated settlement if a breach occurs.

**“Generally you should only grant exclusivity after an acceptable offer has been received and the major features of a deal negotiated and agreed”**

bidders to enhance your company's valuation. Generally you should only grant exclusivity after an acceptable offer has been received and the major features of a deal negotiated and agreed. This milestone is often marked by the buyer and seller signing a heads of agreement (sometimes called a letter of intent) setting out the commercial terms of the deal and a timetable for its completion.

#### What period of exclusivity is reasonable?

The nature of an individual deal will influence how long it will take to close and therefore what a reasonable exclusivity period will be. The complexity of the business to be acquired, its geographic spread and whether the purchaser needs to raise funds

exclusivity to be linked to the progress achieved during the due diligence and legal phases of the sale. It may therefore be sensible to insist on a review meeting after the financial due diligence has been completed (say, after four weeks). At this point the acquirer must confirm that no serious issues have arisen that would put the agreed deal at risk. If this confirmation is forthcoming, a further two to four weeks' exclusivity may be granted; if not, the parties can deal with the issue before moving ahead or alternatively decide to part company.

#### What if I receive an approach?

Exclusivity operates on two levels: what the specific, legally binding terms of exclusivity in

**Need to know more about exclusivity or any other aspect of buying and selling your company? Contact Gordon Blair on 020 7484 4705 or e-mail him at [gordon.blair@livguarantee.com](mailto:gordon.blair@livguarantee.com).**



There are plenty of deals out there in the mid-market – it’s nursing them across the finishing line that’s tricky. Don’t let purchasers call your bluff at the eleventh hour, says Livingstone Guarantee’s deal doctor **Gordon Blair.**

## How to avoid last-minute deal re-negotiations

### Run a thorough internal review

Purchasers and investors use the due-diligence process to manage the risk of doing a bad deal. In this risk-averse M&A climate, due diligence advisers are, bluntly, minting it. Even small transactions involve financial and accounting, commercial, environmental and property, pensions and IP reviews. Private equity houses are spending big bucks in psychometric testing for management teams before they invest. The more due diligence that’s performed, the greater the burden on the target business. And due diligence is likely to bring up issues that could scupper an agreed deal.

Do your own internal review before exposing your business to external scrutiny. Rehearse the process with your advisers. If you know what to expect, you can begin preparing the information requests and look really slick in the eyes of a buyer.

### Maintain business momentum

The most common cause for deals falling over at a late stage is a sudden slide in performance by the target business during the due diligence process. This causes a crisis of confidence for the purchaser or investor that makes them back off. Yet the reason for missing targets is often the preoccupation with doing the deal. With deals absorbing more and more valuable management time, shareholders should be ruthless about maintaining the business’s momentum. One unexpected hiccup – whether it be missing a monthly profit figure or letting a new contract slip between your fingers – can have a disproportionate effect on your chances of completing the transaction.

### Beware of “chisellers”

In this difficult climate, more and more purchasers and investors are trying to renegotiate deals at the eleventh hour. Their excuses range from general economic uncertainty to stock-market volatility but their aim is often the same: to “chisel” at the pre-agreed price, just as the finishing line is in sight. After a tiring eight-month process, it’s hardly surprising that exhausted vendors accept a price reduction just to complete the deal.

The more time you allow for due diligence, the more time you can spend on managing your business during the most intrusive stages of the deal. Make sure that you only break good news to the purchaser or investor – it’s so much harder for a buyer to justify a price chisel when you deliver a monthly profit that’s ten per cent above budget.

If the buyer or investor still brings out the chisel, immediately terminate any period of exclusivity. The best rebuttal to such ploys is to walk away from the deal – ideally, turn to the party who offered the next best deal.

### Choose your purchaser carefully

It is easier for decision-makers to say “no” rather than “yes,” especially when they are ambitious managers being asked to sanction a £10m acquisition. Their deal decisions will often be dictated by their own career agenda rather than commercial logic. It’s often easier to back off a deal than proceed. This isn’t intended as a blanket criticism of purchasers – corporate finance is a personality based-process that brings out the best and worst in people.

To avoid unnecessary delays, set a timetable to completion when you agree the non-binding heads of agreement.

Pick your purchaser with care. Check whether you are a genuinely strategic target for them. Verify that they have the cash available to pay the price and demand main board approval before signing heads and granting exclusivity. Ensure that exclusivity lapses if certain milestones are missed.



#### Dear doctor

I am about to commence an important deal. Who should I appoint and how should I go about it?

#### Dear “first steps”

The first adviser you should appoint is the one who will lead the deal on a day-to-day basis. This should be a seasoned negotiator from a corporate finance firm. Even if you have worked with someone suitable in the past, you should always consider a beauty parade. Find two advisers that seem equally capable of undertaking the role. Provide each of them with a briefing on your organisation and the proposed project, and ask them to make a pitch. Quiz your prospective advisers thoroughly on their relevant experience and the role they expect to play.

#### Dear doctor

How should I proceed when I've found an adviser I like?

#### Dear “love at third sight”

Meet your first choice at least twice before making a decision. Request references and take them up once you have decided to make an appointment. Ask the referee specifically about his experience working with that particular adviser.

You should expect to form a close working relationship with your lead adviser, so the chemistry

Whether you work for a major public company or are an owner-manager, you will need to use professional advisers when embarking upon a corporate finance transaction. Livingstone Guarantee's deal doctor, **Gordon Blair**, tells how to get the best from your advisers, without paying over the odds.

must be right. Your instincts will guide you in this. Be clear with your adviser about what your objectives are and what factors will affect your judgement. The same applies when assembling the rest of the team. Your lead adviser can suggest names, but the decision is yours.

#### Dear doctor

How can I make sure that I am getting value for money from my advisers?

#### Dear “I want my money's worth”

Start off with written quotes from each of your advisers. Ensure that you understand the assumptions upon which the quotation was made. If you believe that those assumptions are unreasonable or inappropriate, say so.

#### Dear doctor

Is it better to agree a time-based fee or one based on the success of the deal?

#### Dear “purse strings”

It depends on the transaction. If a fee proposal is based on time spent, ask for specific charge-out rates and get regular updates during the course of the transaction on costs to date and anticipated costs to completion. Where contingent, success-based fees are involved, ensure that your interests are aligned with that of your advisers.

When negotiating each individual fee, there is a careful balance to maintain. On the one hand, you want to be sure of paying the market rate. On the other hand, value for money is more than just accepting the lowest price. Certainly you should negotiate hard – this will give you a good insight into their negotiating skills – but remember that quality justifies a premium.

Often, transactions take longer or turn out to be more difficult than expected for reasons beyond your control. Your advisers may expect to ask to be paid more as a result. Do not even entertain such a request from an adviser working on a largely contingent basis. They are used to taking the rough with the smooth.

Things are more complex for time-based advisers. They will not be motivated by the prospect of working at a loss when they are not at fault. As soon as this situation arises, agree a basis for working beyond the original estimate. Better still, try to agree a fee cap at the outset.

#### Dear doctor

I have assembled my team of professional advisers and am about to start the project. What is the best way to manage the team?

#### Dear “finger on the pulse”

The personal commitment of your professional advisers is crucial to a successful outcome. The more frequently and effectively you communicate with them, the more you will get out of them.

At each stage of the project, obtain renewed commitments from your team regarding their personal contribution and timetable. Ensure that they know the consequences of letting you down. Do not store up gripes. As soon as you feel that you are not getting the attention you deserve, let them know.

It may be helpful to arrange with your advisers a regular reporting process, such as a weekly update meeting or a specific time of day when you can be contacted. Stay informed of all aspects of the deal, particularly if the project hits a rough patch. The busier you are, the more important effective communication becomes.

#### Dear doctor

My advisers seem to be lost in the detail and are spending more time chasing their own tails than advising me.

#### Dear “bring me solutions, not problems”

It sounds like your deal leader is not being effective in his or her role. This may be your fault. Their job is to give you information that enables you to make decisions, and for you and them to put those decisions into effect. However, sometimes complex tax or legal issues throw some aspects of a deal into confusion. When this situation arises, effective, immediate communication involving you, the deal leader and the relevant expert is essential. Meet face to face if possible and ensure that you are in a position to make a decision by the end of the meeting. Do not commit to a course of action until you are certain – changing your mind later on will waste your advisers' time and your own money.

#### Dear doctor

What is the best way to manage the project internally?

#### Dear “head chef”

Too many cooks can hinder effective communication with your advisers. Wherever possible, have one internal point of contact. You will probably need to involve colleagues, but do so on a selective basis. Where individuals will be materially affected by the outcome, keep them informed as the project develops, but do not allow management by committee. Maintain confidentiality wherever possible and give your advisers consistent instructions.

The Deal Doctor's past prescriptions can be viewed at [www.livguarantee.com](http://www.livguarantee.com). You can contact Gordon Blair by e-mail at [gordon.blair@livguarantee.com](mailto:gordon.blair@livguarantee.com)



Considering a cross-border disposal? Before you start approaching overseas purchasers, consult Livingstone Guarantee's Doctor McDeal, Gordon Blair.

**My business might be worth £12m. Is a company this size really going to appeal to overseas purchasers?**

Small can be beautiful, even when viewed from a long way away. Ten years ago, I would have shared your concern. Then, international purchasers looking abroad for growth were very much focused on targets that gave them genuine critical mass. That meant deals with values of less than £20m rarely caught the interest of the international purchaser community. Today, the corporate world is a much smaller place and I would confidently expect to receive offers from foreign acquirers in 75 per cent of all cases, even with transactions as small as £5m. You should absolutely not be limiting a marketing exercise to just UK buyers.

**So how do I identify an appropriate overseas purchaser for my business?**

The key to identifying a high-quality short list of overseas purchasers is a strong international research capability. Either you invest the time and resources to pro-actively identify buyers or you find a specialist adviser to do it for you. Livingstone Guarantee has been part of an international network of M&A advisers since 1993. Our team of research analysts liaises closely with colleagues in the Global M&A offices, gaining access to those overseas purchasers that domestic UK research may struggle to uncover. A typical purchaser research report will contain information on around 100 very relevant potential purchasers, of which 70 per cent will be based outside the UK. A short list of no more than ten will be put forward as the right strategic partners to contact.

**How do I tell if a potential overseas purchaser will be seriously interested?**

An overseas purchaser's previous history of successfully completing UK acquisitions should be carefully assessed to

determine whether that acquirer has a proven track record of deal-doing in the UK. The greater a foreign group's existing UK resources, the smaller the acquisitions that it is likely to be prepared to consider. In the event that the prospective purchaser has not completed any UK acquisitions, there will be a learning curve for that party, which could introduce delay to the process or limit its interest in smaller deals. However, the fact that an overseas purchaser has

at more or less the same pace. It is often sensible to contact overseas purchasers with an opportunity a week or more before contacting UK buyers in order to enable them to mobilise their resources. The decision-making process of an overseas purchaser also needs to be fully understood from an early stage. Decision-making processes can be very different outside the UK – and often take much more time.

If an overseas acquirer expresses interest and requests

“It is often sensible to contact overseas purchasers with an opportunity a week or more before contacting UK buyers”

not previously made a UK acquisition should not lead to them being side-lined in a sale process. We recently advised on the sale of UK businesses to a listed Icelandic group, an Indian investor, an Italian company and a Canadian company, none of which had previous cross-border experience.” In these circumstances, it is important that there is an obvious strategic and commercial fit with the target company and plenty of evidence showing that the purchaser is acquisitive.

**Do I need to run the sale process any differently with an overseas purchaser?**

With distance comes delay. When running a competitive sale process, it is important that all interested parties are progressing

a management presentation and/or site visit, it is vital that the purchaser's key decision-makers are represented among the visiting team. The presence of at least one key decision-maker will invariably speed up any approval process and avoid “fishing expeditions.” In any event, a purchaser's reporting structure, ability to meet the major process deadlines and any local regulatory or stock-exchange issues should be identified at the outset and factored into the discussions.

Essentially, the principles for successfully completing cross-border deals are the same as for UK deals, albeit with an even greater emphasis on “understanding” the prospective purchaser. By gaining this understanding, it is possible to

anticipate potential pitfalls and, therefore, accommodate a serious potential purchaser whose interest might otherwise be discounted prematurely, simply by dint of their nationality.

**When dealing with an overseas purchaser, what cultural differences might I be faced with?**

I recently advised a vendor of a UK-based business on a sale to a large Italian purchaser. Negotiations had reached an advanced stage by the last week of July and a final draft of the Heads of Agreement had been circulated. Numerous conference calls were held to discuss the outstanding issues, with a number of reminders from the Italians that on August 3 they would be away on holiday and uncontactable until the beginning of September. A conference call on August 2 did not resolve the few remaining issues – and the Italian purchaser, true to his word, departed for the Tuscan hills with his mobile phone turned off. However, as promised, the Italian purchaser dutifully re-appeared at the beginning of September, resolved all outstanding issues and commenced due diligence promptly.

Exchange and completion came eight to ten weeks thereafter. The moral of the story is that when continental Europeans say that they are going on holiday, boy do they mean it!

Generally, an overseas purchaser will look for the same comfort through due diligence and the legal process as a UK purchaser, although there is likely to be a need for a more detailed market and commercial due diligence investigation, especially if the prospective overseas purchaser does not have current local representation. Client referencing can be an important facet of this process. It is important that both buyer and seller gain a clear appreciation quickly if significant customer contact will be required pre-completion.



Moral hazard sounds saucy until you get involved with a company with a pension scheme. Date 'em or dump 'em? Thirty-something Doctor McDeal and his glamorous assistant (pensions specialist **Giannis Waymouth**) look at new pension risks in the M&A dating game.

**A rose by any other name? Do you know what you are getting?**

If you acquire or invest in an employer, you could encounter one of three common types of pension arrangement: a group personal pension plan, a defined contribution pension scheme or a defined benefit pension scheme. With a GPPP or a DC scheme, the employer's liability is mostly limited to paying the contributions on time. With a DB scheme, the member is told what pension he should get and the benefit is provided by a scheme set up under trust. The following relates to DB schemes only.

**Ugly friends: Can I leave pension liabilities behind when acquiring an employer?**

A DB scheme attaches to the sole or principal employer (often the top company in a group). If you acquire shares in the principal employer, the scheme comes too. It is not usually possible to segregate the liabilities for active employees from the pensions and former employees. You can sometimes separate a company from its scheme, but don't try it at home without advice. On an asset purchase, you should not ordinarily get the scheme, but you may still get pension liabilities.

**Who pays for dinner? What determines employer contributions?**

The employer meets all of the bulk of the cost. Contributions are determined by the scheme's rules and overriding law. The scheme rules might give the power to set contribution rates to the trustees, the employer or the scheme actuary. UK statute currently imposes the minimum funding requirement (MFR).

**Posh nosh or cheap and cheerful? What's the right valuation basis to use?**

DB scheme assets and liabilities are valued differently for different purposes. Trustees will

use an on-going basis to value assets and liabilities – this assumes salaries continue to grow and pensions are paid from the scheme. MFR is the statutory basis for valuation, and generally the lowest. It assumes all employees left service the day before the valuation date. A scheme-specific funding requirement (SSFR) will replace MFR from September 2005. "Discontinuance" and "buy-out" look at liabilities on winding up

on the MFR basis at that time (an "employer debt"). This is an immediate liability. By exception, if the scheme terminates (after June 11, 2003) when the employer is solvent, the employer debt is based on the deficit on a full buy-out basis. The Government wants the buy-out basis to apply to all withdrawals, probably from early 2005. This means that it may be cheaper to continue the scheme and spread the cost over time.

associates to provide financial support for the employer's DB scheme, if the employer is either a service company or is insufficiently resourced.

**I have had a relationship with a participating employer: should I be worried?**

FSDs can only go to the employer or a person who is connected or associated. Contribution notices apply to persons in that category in the relevant period which were either a party or a knowing assistant to avoidance of an employer debt. The relevant period starts with the act/failure to act. Individuals generally escape liability, so individual directors or shareholders cannot be issued with an FSD. Partnerships, including limited liability partnerships, are probably going to be caught.

There will be guidance soon. The draft Government guidance suggests a low risk of FSDs if no benefits are taken out of an employer with an underfunded scheme. Extraction of value through dividends increases the risk. Corporate group structures or private equity structures with companies managed independently and with no financial cross-over between them appear unlikely to lead to one company being required to support the pension scheme of another. Purchasers of businesses from companies with an underfunded scheme are unlikely to be affected.

The new Regulator will operate a process for issuing clearances from April 2005.

“If you acquire or invest in an employer, you could encounter a group personal pension plan, a defined contribution pension scheme or a defined benefit pension scheme”

and are similar: the estimated and the actual cost of securing all liabilities with annuities – the most conservative bases. FRS17 attempts to recognise the funding position of the scheme in the employer's accounts. It is not linked to the real funding requirements of the scheme or the employer's ultimate liability.

**Breaking up: can I give the scheme the elbow now?**

If an employer "withdraws" from a pension scheme (ie, if the scheme goes into winding up or the employer goes into liquidation or stops participating), it may have to pay a share of any deficit

**Moral hazard: what your mother didn't tell you.**

From April 2005, "connected parties" may be required to add their support to the scheme. If you are a connected party of an employer with a DB scheme, or acquiring, or raising finance for, such an employer or a connected party, you need to be aware that the new Pensions Regulator will be able to impose financial support directions (FSD) and contribution notices if reasonable to do so. A contribution notice will catch a person involved in avoiding an employer debt, by requiring them to pay a contribution instead. An FSD could be used to require the employer's



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Main market or alternative investment market? Don't even think about a float until you've consulted Doctor McDeal's golfing partner (and IPO specialist), **Nick Rodgers.**

**How large should my company be to seriously consider an AIM float?**

There isn't a critical size. But I would say that to get good institutional interest, something to the order of £25m plus. But there are companies who've gone on to AIM at sizes a lot smaller than that and have grown.

**How established must my company be?**

If you've got the most wonderful idea in the world, of course, you could proceed immediately to flotation. There are companies that are two years old and still in the development phase that have gone to AIM where perhaps they wouldn't have been able to go to the main market. Generally, a three year record is the minimum.

**How long will it take to achieve an AIM flotation?**

You're probably looking at three to four months. The process is generally around a fortnight quicker than the main market. Two weeks may not sound a lot, until you consider it as a proportion of a 13 week period.

**What are the benefits of AIM over the main market?**

One of the principal advantages is speed. The documentation for flotation can be drawn up slightly quicker.

The other major advantage is flexibility in terms of acquisitions. You can buy something quite significant – up to 100 per cent of your size – without having to go back to get shareholders' approval. Whereas on the main market, even an acquisition a quarter of your size would have to be approved. That's a significant advantage for an acquisitive company.

Acquisition documentation on the main market can cost somewhere in excess of £200,000. There are one or two subsidiary advantages too, such as tax preservation and you don't generally trigger EIS relief problems on AIM.

**...and the disadvantages?**

It's still the junior market and for a 'serious' company wanting the highest profile that can be an issue. A lot of institutional

investors are only able to devote a proportion of their funds to invest in AIM companies.

The problem they encounter is that they can use up this allowance. So even though they might be interested in the company, they have to say, "Sorry, I've used up 20 per cent of my portfolio, I can't go any further". They don't have that restriction on the main market.

**Who will my new shareholders be once I have floated?**

You can expect to have the same pool of investors that you could have on the main market. The major institutions are there and will be investing in AIM stocks in

It's sometimes quite difficult for a company to encourage more than one analyst to follow them. So you've got to work at that, but you've also got to work at private clients, and make sure that their brokers are aware of the story. This is where your PR advisor will earn his keep.

Private clients tend to create more liquidity than institutions. They are the people who are going to buy £5,000 of shares at one time. If you sold 100 per cent of your shares to institutions, they'd all say "That's great, we'll keep them for two years", but the share price would not move because there would be no trading in the stock. However,

costs are somewhere in the region of £150,000 to £200,000 per annum.

**What qualities should I look for when appointing the nominated adviser?**

The nominated adviser and broker is the key appointment. Combining these two roles is generally the most efficient and cost effective way. Firstly you need to find someone who can do it. They all say they can – but that doesn't necessarily mean that they can! You need to go to their client base and ring up the ones who have been recently floated. Get as much information as you can on the broker's capabilities.

Finding someone you can work with is the second most important thing to consider, because you'll be working with them quite closely for the next four months.

There are lots of stresses during the flotation process and working with someone you like makes it easier. I would suggest you pick someone who can give you a straightforward answer rather than sell you a story. The best advisers probably won't be the cheapest either.

**As a founder, entrepreneur and former 100% owner, how will my life change once I have floated?**

You no longer own the business and that's the biggest change. You can't adopt the same strategies that you did before, you have to make decisions on a carefully considered basis. You have to start separating your role as manager from that of shareholder, you can't dominate the board. You might have a jumped-up 12 year-old who only has five shares in your company, telling you how it should be run! Learning how to bite your lip will be important!

“On AIM you can buy something up to 100 per cent of your size without having to get shareholders' approval. That's significant for an acquisitive company.”

the same way they'd be investing in main market stocks.

There are very few investors who can't be involved in AIM stocks. Whereas there are quite a few smaller investors who can't invest in the main market – venture capital trusts for example. So, if your company is really attractive to an institutional investor, it shouldn't really matter whether you're on AIM or the main market.

**How do I ensure that I achieve some liquidity in my shares once floated?**

It's a fair question. You've really got to work at it, principally with your brokers. You've got to make sure that your investors are informed and kept fully up to date. Make sure that there's research out there in the market.

if you sell all your stock to private investors, there would be a lot of volatility. You have to get the balance right. There needs to be a reasonably firm shareholder-base to ensure stability and enough trading to ensure liquidity.

**How much will it cost me to float and then to maintain my company on AIM?**

The costs are very similar to the main market. For the sort of company that's valued at around £25m, you're talking about £500,000 to £1m to float. It depends largely on the size of the amount raised. The fixed costs will be about £300,000 or £400,000 with the rest being commission on money raised. Commissions vary but can be between three per cent and five per cent. Ongoing maintenance

Until December 2003, Nick Rodgers was the joint head of corporate finance at investment bankers Evolution Beeson Gregory. He is now an independent consultant advising small quoted groups and private groups considering an IPO. Contact him at [nick@nrfinancial.com](mailto:nick@nrfinancial.com)



### Dear Doctor

How and when should I raise the subject of a buy-out?

### Dear Tactful

This is a delicate topic. Once you've opened "Pandora's box" with your managers, the topic of an MBO can be a difficult one to control. Best therefore to make absolutely sure that a buy-out can deliver you an acceptable result before you talk to your team. Seek out an experienced firm of advisers and invite them to tell you whether or not a buy-out is deliverable and, if so, at what price. If their advice is that you will not be able to achieve the value that you want, do not create a problem for yourself by discussing a buy-out with management. Instead, focus on the trade sale route.

### Dear Doctor

How can I make sure that management offer the best price for my business? Should I invite competitive bids from trade buyers?

### Dear "Asking for trouble"

I always warn vendors that a "savvy" management team will easily and quickly turn those tables on you. Most trade buyers will simply not bid against a management team, because they are not prepared to buy a business and inherit disaffected managers who may leave to seek a buy-in opportunity elsewhere.

Even if some buyers are prepared

The idea of selling your business to your management team may seem attractive: the managers get the chance to control their own destiny and competitors don't hear about the sale until after the event. But don't let the prospect of a cosy deal seduce you until you have consulted Livingstone Guarantee's Doctor McDeal, **Gordon Blair**.

to bid against the management, they are likely to insist on meeting them before making a written offer. The management, in turn, may be tempted to give a downbeat view of future business prospects.

### Dear Doctor

I'm no walk-over. But how do I keep on top of negotiations?

### Dear Control-freak

Tell the management team that you will give them only six to eight weeks to make a detailed written offer on the letterhead of a venture capitalist at an absolute minimum price of £Xm. If they cannot find a backer at that price, then you should expect their total support to sell the business to a trade buyer.

Don't leave your management to devote endless hours to an open-ended and distracting search for funding. A short, simple process means that they will spend more time on managing your business.

### Dear Doctor

My mates tell me that venture capitalists are paying good prices. How do I get to them if not via my management?

### Dear Bewildered

Venture capitalists are prepared to buy businesses worth £10m or more themselves, as principals. You may think that is no different from backing an MBO – but it is.

By acting as principals, venture capitalists are able to compete on price with trade buyers. Once they have agreed a deal with the vendors, only then will they decide on the management's equity stake.

Inevitably, it will be a smaller stake than if the management had initiated a buy-out. If appropriate,

the venture capitalist will inject external managers into the business, because they are calling the shots.

Vcs accept they may be required to bid not only against trade buyers but also against other venture capitalists. More important, trade buyers are happy to compete directly with venture capitalists.

### Dear Doctor

A management buy-in team has just made an unsolicited and unexpected offer. Is it time to book my Caribbean cruise?

### Dear Gullible

A management buy-in team could well show you a letter from a venture capitalist offering to back them to buy a business, possibly up to much more than your business is worth. But beware: it is not a blank cheque, waiting to have your name filled in. It's more like a letter of comfort, sometimes distributed by investors quite indiscriminately, to persuade the buy-in team to come back to the venture capitalist when they find a business to buy.

Don't rule out buy-in teams, but be aware that venture capitalists have to be hard-nosed and dispassionate buyers. They invest purely on the merits of the management team, the business opportunity, and only if the price is attractive to them, as they won't know if any of these are true of your business when they write their letter.

### Dear Doctor

I've heard some worrying stories. Can I really trust my management team or will they stab me in the back?

### Dear Guarded

Only you know the answer to that but it's good to act cautiously. The

vendors of a private company telephoned me to say that their trade press had published an article claiming that their business was about to be sold to the management team. The truth was, they had received an unacceptable offer from management and a decent offer from a trade buyer. The owners were convinced that the management team had deliberately leaked the story to kill off the sale. In these cases, you should appoint experienced corporate finance advisers to keep tight control of the process. If a buy-out fails, the business will never be the same again.

### Dear Doctor

How does management decide who will make up the team and own shares?

### Dear Puzzled

In some cases, this will be obvious but in others there may be a raft of people that the "core" management team wants to include to incentivise them. There is only ever a finite level of equity to distribute to the management team, so the more people involved, the less is available for each individual. The team participating in equity should be those people who are principally responsible for delivering the business performance. There are other ways of incentivising the next tier of management which does not necessarily involve equity but which achieves the same (or in some cases a better) result.

One myth that should be dispelled is that if management put in a little bit more money they will get a larger proportion of the shares. The impact of any increase from management will only be minimal in the overall scale of the deal and consequently any increase in shares would also be minimal.



Tricky market conditions have limited the exit options for venture capitalists and made secondary buy-outs increasingly popular. Should you listen if the proposal is put forward by your VC? Not before consulting Livingstone Guarantee's Doctor McDeal, Gordon Blair.

**My venture capitalist has talked to me about the potential of a secondary buy-out. What is it?**

A secondary buy-out is a transaction whereby your initial private equity partner is replaced by new venture capital funding, with the incumbent management team remaining broadly similar in make up. With the current shut down in the IPO market and the difficulty in finding willing trade buyers who are prepared to make acquisitions at the present time, secondary buy-outs have become increasingly common over the last few years to the extent that they now account for over a quarter of all venture capital exits.

**I don't understand why my venture capitalist wants to explore a secondary buy-out.**

Most private equity investors, having made an investment, are looking for that investment to be realised over a three to five year period. Unless a venture capitalist sees the potential to sell at a significantly higher price in a year or so, then the longer he or she holds the investment, the worse the rate of return. Also, many investments are made from funds which have a finite life span of between eight to ten years. As such, in order to close down these funds and realise returns to the original investors, venture capitalists are often potentially willing to enter into discussions with management on a secondary buy-out.

**Are there likely to be any opportunities to increase my own equity stake going forward?**

In a secondary buy-out, as well as replacing your existing venture capitalist, you can also look to re-leverage the business either with your existing bank or a new debt provider. This obviously gives the management team the potential to receive a larger amount of equity. A number of banks look on secondary buy-outs as less risky than an initial buy-out as they are lending money to a proven team who have worked with a debt funder since the

original deal.

In certain instances, it has been possible for management teams to leverage up the deal completely so that no private equity funding is required, thereby giving management complete control of the business. This is potentially a route to consider, but will probably not be looked on particularly favourably by your current investor as it is unlikely that this will give them the greatest value for their existing stake.

**I have been involved in a successful buy-out, my investor wants to sell and my stake will be worth a tidy**

**“A number of banks look on secondary buy-outs as less risky than an initial buy-out as they are lending money to a proven team”**

**sum. How much will I need to re-invest?**

There is no hard and fast answer to this, but obviously any new venture capitalist will want to ensure that you and the rest of the remaining management team are fully incentivised to make the secondary management buy-out even more successful than the initial one. As such, they will look for you to “roll over” a relatively significant proportion of your proceeds into the secondary buy-out. However, both you and your fellow management shareholders should be able to crystallise some gain at the point of the transaction. Typically this may involve a release of enough cash out in order to be able to repay any sort of major outstanding financial liabilities, such as your mortgage.

**Is it possible for some members of the original buy-out team to leave and for new members to replace them?**

Absolutely. Injecting “new blood” into a successful management team is generally seen as a positive sign by an incoming venture capitalist as long as their skills are complementary to the incumbent team.

However, you need to think carefully both about the type of person you want to join your team and also the amount of money that the new person has available to invest in a secondary buy-out. It does sometimes cause issues when newcomers join an

not being willing to give any warranties. Any new funder will require certain warranties from the management team as vendors. This obviously has the potential to get somewhat nasty should issues arise after the investment, as the funder may need to sue their own management team – not a very tenable situation. These issues can be mitigated by using warranty insurance, but the costs and timing implications of this need to be fully considered at an early stage in the secondary buy-out process.

**I have already been through a secondary buy-out and am now looking to exit. What can I do?**

Tertiary or even quaternary buy-outs are becoming increasingly prevalent across all deal sizes, so this route should not necessarily be viewed as a last resort. However, as in any secondary buy-out, you do have to consider the eventual exit route very carefully as any incoming venture capitalist will be keen to realise the investment via a trade sale or flotation. Therefore questions will inevitably be raised if no trade exit has been achieved a number of times.

**My new funder also wants to put in place a draconian shareholder agreement that is similar to the one we signed for the initial buy-out. Is this right?**

Although this might not seem fair as you have proved yourself as a management team already, any new funder will still require a detailed shareholder agreement setting out the rights and duties of all the investors (including yourself).

There is no way of avoiding this agreement, but you will need to get a commercial and pragmatic lawyer to work on your behalf to ensure that you get the maximum protection for your investment going forward.

**I am currently going through a secondary buy-out and am being asked to give warranties to my new funder. This doesn't seem fair.**

One of the major points for discussion in any sale process is the perennially thorny issue of warranties. This is potentially a major issue in all secondary buy-out situations as a result of the initial private equity funder

Got a burning question of your own for Doctor McDeal? Please e-mail your queries to Gordon Blair at: [gordon.blair@livingstone.com](mailto:gordon.blair@livingstone.com)



The buy-out industry suffered a mild paralysis when the Finance Act 2003 revisited the tax status of equity shareholdings in management buy-out and buy-in vehicles. **Gordon Blair**, Livingstone Guarantee's Doctor McDeal, explores this complex condition.

**I am considering a buy-out and my private equity backer has been talking to me about how she requires a minimum “money multiple” before she makes an investment. What is that?**

Private equity investors have historically focused on internal rate of return (IRR) as the primary benchmark for determining the return they would like from an investment. More recently, however, they have focused on the actual cash return they achieve on a successful transaction. Ideally, they want to double or triple the cash value of their investment over a three to four-year period.

**That's fine. But I don't understand why she talks about my money multiple being 30 to 40, when she only needs two or three.**

Ah, the beauty of leverage. Your prospective investor will be investing just a small proportion of her overall investment in equity, with the vast majority (90 to 95 per cent) being invested in a loan-type instrument that pays interest. Your backer's return is based on getting her loan repaid and making “big” money on her equity investment. Your investment will purely be in equity and, assuming a successful exit, your returns could well be 40-50 times your original investment.

**So my original £100,000 investment could make me £3m to £4m. That sounds too good to be true?**

If the original deal was structured correctly, and you have achieved everything that you set out to under your original business plan, and you are able to complete a favourable exit (now doesn't that sound easy!), then achieving those returns is a realistic objective. But remember: at this point, one of those two certain things in life comes along – taxes.

**I never like taxes, but all the financial press talks about is paying a ten per cent tax rate on a capital gain on the sale of a business. I don't mind paying that.**

The books were right until the

2003 Finance Act, although lately things have got a little bit more complicated. Generally, if you had held your shares for more than two years and followed relatively simple guidelines, achieving an effective tax rate of ten per cent on your capital gain was achievable. Unfortunately, the Inland Revenue has decided to make things a bit more complex of late.

**Sound ominous – what's changed?**

Last year's Finance Act introduced new tax rules for shares held by employees or directors, with the most important change being the

which the restriction devalues the shares will be the percentage of the eventual sale price for the shares that will be charged to income tax on their disposal.

For example, if restricted shares are issued to the management at 50p per share, this price reflects their value taking into account the applicable restrictions. But without these restrictions, the shares would be worth £1 each. In this case, 50 per cent of the value of these shares on exit will be subject to income tax and National Insurance when they are sold (with the remaining 50 per cent being subject to capital gains tax).

“Private equity investors rely on your investment – and subsequent shareholding – in Newco as the most effective means of incentivising you and your team”

introduction of a new set of rules for “restricted shares”. These restricted shares are common to most buy-outs as they include restrictions such as “tag-along” rights (which give the managers the right to sell their shares if the private equity provider sells its shares), “drag-along” rights (which require the managers to sell their shares if the private equity provider sells its holdings) or an obligation to sell or forfeit shares if the manager retires early or under a cloud.

**So what's the potential effect on me?**

At the time of the initial buy-out, the Inland Revenue will compare the value of the restricted shares with what their market value would be without that restriction. The percentage by

**Oh – could be nasty!**

It could well be. Instead of achieving ten per cent effective capital gains tax rate on the total gain, you would have to pay income tax at 40 per cent and National Insurance on half of your gain. Fortunately, over the last few months detailed, and complicated, guidelines have been agreed with the Inland Revenue. If followed to the letter, these may mean that restricted shares issued in a management buy-out may not fall under the income tax regime at a later date.

**So why is the private equity industry up in arms?**

Private equity investors rely on your investment – and subsequent shareholding – in Newco as the most effective means of incentivising you and

your team to deliver on your business plan. If the eventual effect of the Finance Act 2003 is to make management's investment hopelessly tax inefficient, the incentivisation aspect of your equity will become hopelessly diluted. Worse still, existing forms of Inland Revenue approved share schemes (such as EMI schemes) only serve to deliver relatively small values of equity into managers' hands.

**What are these guidelines?**

Broadly speaking, there are six key conditions as set out in the following Inland Revenue clauses:

- i. Management shares must be ordinary shares;
- ii. Any shares ranking ahead of the ordinary shares must be on “commercial” terms;
- iii. Management must pay the same price for their shares as other investors;
- iv. Management must acquire their shares at the same time as other investors;
- v. Management shares must not have any rights over and above other ordinary shareholders;
- vi. Management must continue to receive “regular” remuneration through salary and bonuses.

**All seems a bit complicated. Which of the conditions cause the most problems?**

Numbers ii and v are the tricky ones. The Inland Revenue (on clause ii) defines “commercial” terms as being at least as high as external debt. Therefore, in theory, venture capitalists must be paid at least the same level of interest as the bank. This is not always possible unless the business has strong cash-flow because the banks won't allow it.

Clause v makes it difficult for the management to achieve a “ratchet” i.e. if the business beats the business plan, the management gets a greater shareholding.

**How can I protect my position?**

This whole area is still taking shape. You must take tax advice from a specialist tax adviser familiar with the buy-out market or you could have a very large tax bill on exit. If you are unsure where to turn, call Gordon Blair on 020 7405 4709 or e-mail [gordon.blair@livingstone.com](mailto:gordon.blair@livingstone.com)



### Dear Doctor

There seem to be hundreds of venture capitalists to choose from. How do I select a short list?

### Dear spoilt-for-choice

VCs are differentiated by preferred size of transaction; sector preference and experience; timescale to exit; and degree of involvement with investee companies. The right VC is likely to be one that matches your own circumstances and outlook. If, for example, your deal is smaller than most undertaken by a particular VC, you may struggle to keep their attention both while the deal is completing and subsequently. If on the other hand you desire to grow by acquisition, the appropriate VC will need both the necessary extra funds and the appropriate timescale to exit.

The experience of your financial adviser is crucial here. Venture capitalists are becoming increasingly differentiated, and picking three or four with a genuine hunger to do the deal is vital. This requires personal, first-hand experience of completing transactions with VCs across a range of circumstances. When you are at the point of picking your preferred partner, make sure that all significant legal and financial issues are agreed. Once the decision is made, you will have to work as a team, so do not leave difficult issues un-addressed.

The group chief executive has given you the green light for a management buy-out, but you know he won't give you any special favours, and you need to work to a tight deadline. **Gordon Blair**, Livingstone Guarantee's deal doctor, advises how best to ensure you get the right deal from your venture capitalist.

### Dear Doctor

We have attracted a number of competing offers of support, but their complexity and the amount of jargon leaves us little the wiser.

### Dear dazed and confused

Funding for buy-outs has become highly specialised and inevitably complex. It boils down to finding the right balance between risk and return for each of the parties involved. The venture capitalist will seek to maximise its return and ensure, at the least, that it gets its investment back. In most cases, its investment will consist of a small amount of ordinary equity to provide the bulk of the return and a large amount of loan notes that are there to reduce risk.

For the management, return comes solely from their holding of ordinary shares. Their main risk, apart from losing their original investment, consists of employment security (and as a consequence, their shareholding) and control of the business.

The detailed negotiation of these issues will require expert legal and financial advice.

### Dear Doctor

How important is it for management to get over 50 per cent of the equity?

### Dear control freak

In most situations, control of more than 50 per cent of the equity is an important financial, legal and emotional hurdle. In a buy-out, however, the position is more complex. The financial institutions will seek to impose a veto on anything that falls outside the broad conception of what the business was at the time of the transaction. In addition, they will want to ensure that the management

team does not get rich out of the deal before they do and will want the right to take control if things go wrong. They will seek these rights regardless of the equity split.

In terms of day-to-day management, equity holdings are relatively unimportant. Very few VCs want to get involved in the running of the business and even fewer could do it if they tried.

From a financial standpoint, the value of the management equity only crystallises upon exit and is determined by the value of the business at that time and the amount that has to be repaid to institutions before the management share comes into effect. Therefore, the value of an equity stake can only be assessed in light of the overall financial structure.

### Dear Doctor

What happens if one of us wants to leave?

### Dear "I'm outta here"

VCs approach this issue with two principles. The first is that they did the deal with a certain management team in mind and much of the value lies in that team. Secondly, they do not want a manager to realise value before they do – a point of view that the other managers may share.

From the management team's perspective, there are two opposing points of view. An individual manager who leaves wants some reward for his efforts. The other managers, however, need to be able to deal with underperformers and do not want to reward someone who is about to join a competitor.

It is in no-one's interest to have former managers remain as shareholders, so "good leaver/bad leaver" rules should be agreed at the outset to determine how a departing

manager's shares are to be valued.

Different VCs will have different approaches to this issue, ranging from the ruthless to the indulgent. The issue and all its ramifications need to be considered carefully at an early stage.

### Dear Doctor

Who has the final say when it comes to an exit?

### Dear "a hard rain's a gonna fall"

Most exits are by way of trade sale and the attitude of the management to a particular purchaser will affect that buyer's appetite and the price they offer. Things will have to have gone very wrong for a business to be sold against the wishes of the management.

No purchaser is likely to be interested in buying less than 100 per cent of a company's shares, so the respective powers and obligations of investors and management in the case of an approach should be agreed at the time of the buy-out. Referred to in the business as "drag-along, tag-along," these provisions will specify the circumstances in which dissenting shareholders are obliged to accept an offer that the others find acceptable. The threshold for the ability to "drag-along" dissenting shareholders needs to be considered carefully. Once again, the search is for common ground between management and investor.

The Deal Doctor's past prescriptions can be viewed at [www.livguarantee.com](http://www.livguarantee.com). You can contact Gordon Blair by e-mail at [gordon.blair@livguarantee.com](mailto:gordon.blair@livguarantee.com)



Buying a struggling business at a knock-down price may sound like a dream deal, but the risks can be high and there may be some hidden surprises along the way. Play your cards carefully, says Livingstone Guarantee's deal doctor Gordon Blair.

## Buying from the receiver

### Be prepared to move quickly

Make sure you know the market that you are moving into and use appropriate expert valuers who will quickly give you their opinion as to the worth of the assets you wish to buy. The receiver is unlikely to help with this!

Don't be under the illusion that you can set your own deadlines. They are likely to be very tight so be prepared to move quickly. However, if you are buying a business and the premises in which it operates, a receiver will often agree to you buying the business and letting you run it from the property for a short time on a licence (for a fee) while you carry out the necessary property searches. If you do subsequently buy the property, the licence fee should then be deducted from the sale price. If not, the receiver keeps the licence fee and, assuming he has got you to sign the usual form of agreement, ejects you from the building at the end of your licence period.

### Know what you are buying

Once you have the sales pack from the receiver (you'll probably have to sign a confidentiality agreement for this), try to meet with the receiver as early as possible to fully understand the nature of the assets available. The sales pack will only portray the upsides and a meeting will help to reveal the downsides! The dialogue with the receiver should also enable you to ascertain whether your offer would be more favourably viewed if certain assets were to attract a higher proportion of the offer than others.

Don't be afraid to bid for part of the assets for sale if you do not want to buy them all – a receiver will break up the business if he can get more for it than selling it as a whole.

### Check for contingent liabilities

Consider whether there are any environmental problems in relation to any land/property that you wish to buy; if there are, you can be liable for the costs of the clean up once you become the new owner.

Always check which assets are to be transferred subject to lease or hire purchase, because you will need to carry on making the relevant lease/hire purchase payments if you wish to keep them.

Remember to study all the employment histories of the employees, so that you know the potential liability that you will be taking on. Under the TUPE legislation, you may inherit all the redundancy liabilities, so check the histories of any employees that the receiver has dismissed prior to the sale.

It is also wise to take your own independent tax advice if you want to buy any tax losses accrued by the company.

### Study the small print

The receiver is not personally liable and will give you no warranties or guarantees, especially in relation to ownership of the assets. You therefore need to study the provisions in the sale contract for retention of title claims.

Make sure you check the position with regard to VAT, particularly in relation to properties; an unexpected charge to you of 17.5 per cent on the acquired assets will prove most unwelcome!

Receivers usually retain ownership of the records, but you should ensure that you have access to them. Make sure you know whose responsibility it is to complete any contracts in progress, who is going to pay for doing this and who is entitled to the proceeds of sale. Note that much of the receiver's sale contract is non-negotiable.

### And finally...

Be cautious – keep in mind what you think the assets are really worth and don't get carried away just because it's a high-pressure scenario.

# Livingstone Guarantee

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