

Livingstone



PRACTICAL GUIDE

SELLING SUBSIDIARY COMPANIES

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Livingstone

Livingstone has set the standard for mid-market mergers and acquisitions advice since the organisation was established in London in 1976. Today Livingstone employs 75 staff across four offices in the United Kingdom, United States, Spain and Germany.

Our exclusive focus on unquoted corporate finance advice and experience of completing over 500 transactions has enabled us to build the leading M&A and private equity advisory house specialising in cross-border transactions with values of between £10 million (\$20m) and £100 million plus (\$250m).

We deliver creative corporate finance solutions to successful entrepreneurs, major corporations and private equity investors around the world from our teams in Europe and the United States. We offer strategic guidance and practical support regarding:

- Exit strategies
- Company sales
- Corporate acquisitions
- Management buy-outs and buy-ins
- Capital-raising
- Debt restructuring
- Public Company Advisory
- Cross-Border Deals

Livingstone focuses on five core sectors and has dedicated teams operating in the Business Services, Consumer, Industrial, Healthcare and media:tech markets.

We deliver an outstanding service to our clients by creating dedicated, partner-led teams drawn from the significant resources and expertise of our offices in London, Madrid, Chicago and Düsseldorf.

Our ability to provide clients with a seamless infrastructure for trans-Atlantic deals is unique in the mid-market and supported by an exceptional pedigree for completing cross-border transactions all around the world.

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I Preparing for a sale

Why sell?

The continuous drive to maximise shareholder value means that groups must consider:

- divesting non-core businesses to focus on major opportunities;
- unlocking cash to pay down debt;
- unbundling a group where the aggregate value of individual businesses could significantly exceed the present market capitalisation; and
- selling unwanted businesses which come with a major acquisition.

What are the alternatives?

It is important that all the alternatives are considered before committing to a preferred exit route. Alternative exit routes which may be appropriate include:

- either a 'controlled' or 'covert' auction to a relevant combination of trade buyers, financial buyers, management buy-out or buy-in teams;
- retaining a significant minority equity stake when pursuing a stock market flotation or selling to a financial buyer or management team; and
- a stock market flotation of a subsidiary on either the Main Market, AIM, Nasdaq or Easdaq as appropriate.

The sale process – an overview

Every sale exercise is different, however, the process always involves:

- a preparatory stage;
- a marketing stage; and
- a deal management stage.

These stages are addressed in greater detail in this guide. In general, vendors should allow about six months from commencing the sale process to achieving legal completion. In the event that the ultimate buyer is located overseas or needs to raise external finance (e.g. by way of rights issue or placing), this could extend to seven or eight months.

Appointing advisers

The principal function of any corporate finance adviser should be to achieve the best possible price, improving the likelihood of a successful outcome and to take on the burden of project managing the sale, so that both group and subsidiary management focus on what they do best – managing the business and maximising the profit. When selecting advisers, a group should seek:

- a track record of successfully completed deals, for corporate vendors;
- an international potential purchaser research and delivery capability;
- an experienced deal leader committed to making the deal happen;
- a cost effective fee proposal tailored to incentivise the adviser to achieve an attractive valuation; and
- the opportunity to obtain personal references by telephoning clients for whom the deal leader has sold businesses.

There is a strong argument for beauty parading at least three prospective corporate finance advisers and for choosing different types of advisers to meet. The choice should include an investment bank, an accountancy firm and an independent investment banking boutique, such as Livingstone.

Each adviser should be asked to identify likely buyers, to give an informed opinion of realisable value and to recommend an optimal process and timetable, as part of their presentation.

The corporate finance market is a competitive one and fees are largely comparable amongst advisers. Your adviser should be incentivised to deliver a successful deal by making a large proportion of any fee contingent upon achieving legal completion.

Where you are contemplating a major acquisition which will bring with it one or more unwanted subsidiaries, consider asking your preferred adviser to undertake some preliminary purchaser research and valuation work to assess how saleable those businesses are and the likely values achievable.

Grooming a business for sale

By 'grooming' a company for sale, groups can significantly improve the likelihood of a sale and the total price achieved. Action to take includes:

- maximising and managing profitability to demonstrate a steady and sustainable year on year increase in profits;
- implementing opportunities for cost reduction and short term profit improvement which will not damage the commercial well-being of the business;
- ensuring that the company's statutory and tax affairs are in order; and
- extracting any surplus property assets with development potential from the company, tax effectively.

Finding the right purchaser

A key to maximising shareholder value is to identify purchasers worldwide which have the most to gain from acquiring the company. The greater the potential benefits likely to flow from the deal, the greater the premium price which a buyer is likely to pay. Vendors should identify buyers with:

- complementary products, services or technology but with a gap which the company could fill;
- a gap in their distribution network which the company can complement; and/or
- a known appetite to acquire businesses with similar characteristics as part of a committed growth strategy.

Purchasers with any of the above qualities and adequate financial resources should be short-listed as worthy of approaching.

It is essential to devote considerable time and resources to research on a worldwide scale to produce a comprehensive list of known serious buyers. This requires a conversation with the key decision maker to find out in which market segments they are committed to making acquisitions in a particular country, the strategic rationale, the organisational fit and the likely range of deal values for acquisitions they will make. Out of these conversations, it should be possible to identify a short list of up to 10 buyers to be contacted with the opportunity.

Should you consider an MBO?

Some groups regard a management buy-out (MBO) as a quick and low risk alternative to a trade sale. If the buy-out attempt is unsuccessful, however, the result is likely to be a demotivated management team which has been distracted from running their business for several months. So sales and profits are likely to have deteriorated.

If the group wishes to give management the opportunity to stage a buy-out, it should do so either before initiating discussions with trade and financial buyers or after having conducted such conversations unsuccessfully. It should also:

- set a specific target price, having taken independent corporate finance advice as to an appropriate 'fair' valuation;
- give a specific period of time, typically four to six weeks, without granting formal exclusivity, for a venture capitalist to make an initial written offer; and
- not indemnify the management against any costs they may incur until they make an acceptable offer.

Alternatively, it is possible for your investment banking adviser to contact potential financial buyers directly with the opportunity, before involving local management. By doing so - potentially in parallel with marketing the company to trade buyers - it is generally possible to establish the value and principal terms on when a private equity deal might be achieved.

Valuation

There is no single correct answer to the question of how much an unquoted company is worth. Factors which affect valuation include:

- the recent, current and forecast profits and cash flow of the company;
- the scope for the purchaser to unlock synergies;
- the scarcity value of the company;
- the quality of incumbent management;
- defencibility of market share; and
- the value being placed on comparable unquoted and quoted companies in the sector.

An independent assessment of realisable value may provide comfort for vendors, by enabling them to decide a target value to be exceeded and a minimum acceptable price.

The true value of any unquoted company is not what the vendor or a single purchaser thinks that it is worth. It is the most attractive price negotiated as a result of several serious purchasers submitting written conditional offers to the vendors, without an asking price being revealed.

If the group or its adviser can create a competitive bidding situation amongst a short list of purchasers, the highest offer received is likely to be significantly higher than the lowest one. So an unsolicited offer should be handled cautiously, and if a decision to explore a sale is made then other known serious buyers should be introduced quickly.

When should you inform management?

Some groups are understandably concerned about informing the management team of the subsidiary about the sale until it has been established that acceptable offers will be received for it. One major advantage of appointing corporate finance advisers is their ability to discreetly market the business to a short list of potential purchasers and obtain written conditional offers for the business prior to management being informed.

Should you incentivise management?

Knowing that their business is for sale inevitably creates a distraction and uncertainty for the management team. Experience has shown that a group's interests are often best served by creating a bonus scheme for management to incentivise them to help the group to obtain the highest possible price for the business. The scheme should deliver to the two or three key directors between six and eighteen months' basic salary, based on the price obtained.

Should the sale be publicised?

For some groups, a sale of a non-core subsidiary is a measured reaction to institutional shareholder or stockmarket pressure. So there may be an understandable desire to make a public announcement at an early stage.

A public announcement may achieve the desired result with shareholders and flush out interest from potential purchasers, but the group seriously risks making itself a hostage to fortune. In addition to creating a sense of uncertainty throughout the business, unsettling customers, suppliers and staff, and potentially demotivating management, all of which may affect financial performance, a successful sale is never guaranteed.

So it may make more sense not to make a public announcement until after broadly acceptable indicative offers have been received from several credible purchasers, and management has been informed of the decision and suitably incentivised to achieve the desired result.

This may only, however, be possible if the group has access to all the information on the non-core subsidiary required to enable the corporate finance adviser to understand the opportunity fully, assess its likely realisable value, and prepare an appropriately detailed sales memorandum. If such information cannot be readily accessed, the vendor may have no choice but to disclose to senior management the intended sale.

2 Marketing the opportunity

Marketing & confidentiality

Unless it makes sense to publicly announce a controlled auction (see below), the active marketing of any company to potential purchasers is a highly sensitive process. Maintaining confidentiality within and outside the company is important.

The risk of a breach of confidentiality can be minimised by careful management and control including:

- restricting talks to a short list of serious purchasers which are known to be interested;
- requiring every prospective purchaser to enter into a legally binding confidentiality agreement;
- drip feeding information to purchasers on a 'need to know' basis to allow meaningful offers to be submitted; and
- not informing employees, customers or suppliers until the sale has been completed.

A purchaser's first impressions of a company are frequently based upon the initial information provided by the vendor. Particular care needs to be taken to present the company in the most favourable light at the outset.

A concise information memorandum which provides an upbeat, pithy introduction to the company should be prepared and released to the relevant decision maker. The opportunities for the future development potential under new ownership should be emphasised. Its principal purpose should be to prompt a meeting between buyer and seller – and no more.

Initial meetings

Initial meetings with purchasers should be held on 'neutral' ground at your adviser's offices or a nearby hotel, to avoid prejudicing confidentiality. Initial meetings serve two equally important purposes. Purchasers should have an opportunity to understand more fully the business and the opportunity it presents. The group should assess each purchaser to gauge their interest and ability to deliver an attractive deal.

A target or acceptable price should not be revealed at this stage, because it creates a ceiling on likely offers. Prospective purchasers need to realise that competing bids are being sought

Site visits

Serious purchasers should be allowed a 'whistle stop' tour of the facilities, where the facility is an effective showcase for the business. Purchasers are often reluctant to make a detailed written offer without viewing the premises. However, such access needs to be carefully controlled and is not always additive (e.g. there is little to be gained by walking buyers through floors of workers' cubicles!)

The group or its advisers should accompany one or two members of the purchaser's team around the premises. Questions should be saved until a meeting is convened off-site immediately following the visit.

Following the site visit, and provided the purchaser is still interested, limited further information should be made available on the understanding that a written conditional offer will be made. A key part of this information is likely to be the latest management accounts, latest forecast for the current year and projections for the next several financial years.

If management have not been informed of the decision to sell, initial written offers will need to be obtained 'site unseen'. Then selected prospective purchasers should be invited to meet management and see the premises, before submitting a definitive offer.

Offer letters

At this stage purchasers should have an adequate understanding of the business to enable them to submit a detailed written offer, setting out:

- the price to be paid;
- key conditions; and
- a timetable to completion.

Once written offers have been received from prospective purchasers, time should be taken to fully understand each one, requesting explanations where necessary.

The group should then decide, with its advisers, which is the preferred purchaser. This decision may not simply be based upon price and may include assessments of:

- structure of the offer;
- deliverability of the offer;
- acceptability to the management team; and
- timetable.

A second purchaser should be kept 'warm' in reserve if for any reason the preferred purchaser does not deliver.

Negotiations

The preferred purchaser should be invited to meet with the specific intention of agreeing a mutually acceptable deal. Decision makers with the necessary authority need to attend.

Most groups prefer their advisers to lead the negotiations as this gives them the flexibility to distance themselves from the discussions.

The outcome of a successful negotiation meeting should be 'heads of agreement' (sometimes known as a 'letter of intent'). The heads are a written record of the key features of the agreed transaction set out in commercial language. These should be used by both parties to brief their lawyers and other advisers to be involved in legally completing the deal.

Heads of agreement are not intended to be legally binding, with one important exception. Most purchasers will require the vendor to enter into an exclusivity period with them, barring them from talking to other purchasers for a reasonable period, generally up to eight weeks.

Controlled auctions

Controlled auctions - so favoured by investment banks on much larger transactions - should be used selectively. They bring advantages and disadvantages, so a measured decision must be made.

The advantages include:

- the ability to set a tight timetable to legal completion;
- the opportunity to flush out indicative values early on; and
- usually trade buyers, financial buyers, and possibly an MBO team are prepared to compete against each other.

The disadvantages include:

- controlled auctions only work for 'must have' targets;
- the sale is public knowledge from the outset;
- indicative valuations will be poorly informed and potentially 'tactical'; and
- if the auction does not result in a sale, staff and customer loyalty may be harmed.

Before deciding to use a controlled auction, independent corporate finance advice should be obtained to assess the saleability of the business and the likely price achievable. This requires a rigorous assessment of prospective purchasers to make a realistic assessment.

Comprehensive preparatory work is essential before the sale is announced to ensure that the timetable is achievable. The controlled auction process involves:

- compiling a detailed information memorandum sufficient for prospective purchasers to make a meaningful written offer, without the opportunity to meet the management team or to see the premises;
- setting a timetable for each stage through to legal completion;
- deciding whether or not to allow an MBO team to take part in the auction;
- formulating an incentive bonus for the managing director and finance director, related to deal value, for their help in selling the business to a third party;
- notifying management and staff of the intended sale;
- press releasing the sale of the business and announcing the closing date, typically about five to six weeks, for receipt of written offers;
- contacting a long list of potential trade and financial purchasers and soliciting indicative offers off the information memorandum alone;
- selecting a short list of buyers to meet the management team and to submit an amended written offer;
- creating a data room so that short-listed buyers have access to detailed information on which to base their amended offers;
- preparing the draft sale and purchase agreement to be given to short listed buyers;
- selecting a preferred purchaser, and keeping one in reserve; and
- moving quickly to legal completion.

Controlled auctions are complex and time consuming. Previous experience is essential. Consequently, many groups use corporate finance advisers to provide the necessary resources and expertise.

3 Steering the deal to completion

Due diligence

Due diligence is the opportunity for the preferred purchaser and its advisers to undertake a detailed investigation of the business.

The due diligence exercise will involve a review of the following areas:

- commercial performance;
- financial performance;
- accounting controls;
- property and asset valuation;
- tax and pensions issues;
- legal issues; and
- environmental issues.

It will involve the purchaser and its advisers spending some time at the company's premises reviewing original documentation, but as much work as possible should be carried out off-site.

The due diligence process must be controlled carefully by the vendor or its advisers in order to guard against it being used as an excuse for renegotiating the deal and to ensure that confidentiality is maintained within the business.

Lawyers

Conventionally, a preferred purchaser's lawyers will prepare a first draft of the legal contract. However, increasingly corporate vendors prefer to instruct their lawyers to draft this document. This is almost always the case in controlled auctions. It is in every vendor's interest to secure the best possible legal advice, and time should be taken to select legal advisers who:

- are specialists in the legal aspects of buying and selling companies;
- are willing to commit a seasoned partner to lead the deal from the front; and
- offer competitive fees.

If the vendor's current lawyers have the requisite depth and breadth of expertise, their existing knowledge of the company may be valuable. There is merit, however, in beauty parading up to three law firms and obtaining a written fee estimate from each one, to find the right combination of relevant experience, cost and suitable chemistry.

Legal negotiations

The vendor should request first drafts of the necessary legal paperwork at an early stage, to ensure that the purchaser is not being unreasonable.

Negotiation of the legal documentation may take three or four weeks. Buyers and sellers often believe that, once they have 'shaken hands on the deal', their lawyers can take care of everything. This is a dangerous misconception and it is vital that both parties, and especially their corporate finance advisers, keep totally involved in the latter parts of the deal.

A large part of the legal negotiations will focus around the warranties to be given to the purchaser about the company. This will require the group to consider each warranty carefully with the subsidiary's management and, where necessary, to make disclosures against the warranties in a 'disclosure letter'.

Completion

Completion cannot come soon enough for many vendors. If the sale process has been managed effectively, the group should be confident that they have truly maximised the value of the business whilst delivering it to a purchaser which will continue to develop it.

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