

# Livingstone



## PRACTICAL GUIDE

MAKING SUCCESSFUL UNQUOTED ACQUISITIONS

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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 65 staff across three offices in the United Kingdom, United States and Spain.

Our exclusive focus on unquoted corporate finance advice and experience of completing over 400 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 and divestments
- Corporate acquisitions
- Capital-raising
- Buy-outs and buy-ins
- Debt restructuring

Livingstone focuses on five core sectors and has dedicated teams operating in the Business Services, Consumer, Industrial, Media & Marketing and Technology 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 and Chicago.

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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# 1 Strategy

## Getting it right

Management research confirms that more than half of all acquisitions fail to deliver the expectations of the purchaser. No matter how sound the strategy, successful acquisitions depend on first-class transaction skills and effective post acquisition management.

## What are the alternatives?

At the outset, a prospective acquirer should be satisfied that an acquisition is more appropriate than the alternatives of:

- accelerated organic growth;
- greenfield investment;
- recruitment of a management team; and
- strategic alliance.

Acquisitions make sense to achieve market leadership or increase market share, secure new distribution channels or complementary products, services and technologies, and obtain immediate critical mass when entering new markets. In particular, acquisitions accelerate expansion where market share is the key to success.

However, in certain sectors there are clear reasons why alternative routes of expansion should be considered first. For example, why pay substantial goodwill for a 'people-based' consultancy business when you might be able to tempt the key staff and consequently their customers away at the much lower cost of an increased overhead?

Today, management teams are frequently under pressure from their institutional shareholders to deliver above average growth. For well thought-out strategic reasons, acquisitions play a key role in enabling expanding groups to fulfil their goals and ambitions.

## 2 The acquisition profile

### Finding a good fit

Having established that an acquisition is the best way forward, the first key step is to develop a one-page Acquisition Profile, describing the characteristics that a target company must possess to fit your strategic goals.

In particular, the following areas should be addressed:

- nature of products and services;
- minimum levels of turnover and profitability;
- minimum market share and growth prospects;
- types of customers and nature of relationships;
- acceptable dependency on individual customer and suppliers;
- location and geographic coverage;
- opportunity for rationalisation and integration; and
- management continuity.

In addition, the Acquisition Profile should address the type of deal you consider appropriate, for example:

- minimum and maximum deal values;
- maximum proportion of goodwill payable at legal completion;
- form of consideration: cash and/or shares;
- availability of loan notes as an alternative; and
- desirability of earn-outs or deferred consideration.

The Acquisition Profile provides the basis for the individual executive to seek and obtain board approval for the acquisition strategy. Without such approval, delay, embarrassment and loss of credibility may result later. The Profile is the principal reference point – a template – against which any possible acquisition targets should be assessed.

Making successful acquisitions requires the discipline to say ‘no’ to inappropriate targets quickly, to avoid wasting precious management time, and the flexibility to allow the Acquisition Profile to evolve, should it prove to have been either too restrictive or too widely drafted.

## 3 Identifying targets

Identifying the right target is a crucial part of the acquisition process. It may take the equivalent of one full year to successfully complete the first acquisition and finding suitable targets is often the most time-consuming stage. Purchasers have four options when considering how best to generate relevant opportunities:

### Using your own knowledge

Many completed acquisitions happen between companies that enjoyed an existing commercial relationship before the deal is done, eg. customers, suppliers and competitors. In searching for attractive targets within existing markets, start by using your own knowledge.

Encourage your senior sales and marketing staff to look out for information on relevant companies and report back events – the retirement of the owner, the sudden departure of a managing director, the loss of a major contract – which might make owner managed businesses responsive to an offer.

### Putting bread on the water

A ‘passive’ means of generating deal flow is to circulate your Acquisition Profile. Investment banks and corporate finance boutiques always welcome this information as they are regularly retained by their vendor clients to sell businesses. Importantly, no finder’s fee should be payable by the acquirer.

Outline your acquisition requirements in annual reports and external PR material. When announcing a successful acquisition, say you are seeking more.

These approaches are unlikely to deliver enough opportunities and a high proportion of the targets that are brought to your attention will not fit your Acquisition Profile. More importantly, where advisers are bringing you potential targets, they will normally be contacting competing bidders to create an auction. Opportunities for buyers to acquire attractive targets at low prices are limited in a properly orchestrated auction.

### ‘Business wanted’ advertising

Selective advertising is a more proactive approach to generating deals, albeit on a ‘scattergun’ basis. Experience has demonstrated that advertising is more likely to succeed when the market sector faces a difficult economic environment. Anonymous ‘box’ advertisements simply do not work. This should come as no surprise as what vendor in his or her right mind responds to such an advert, as it may be a competitor!

The most successful form of ‘business wanted’ advertising uses corporate finance advisers to sponsor the advert. An adviser can offer several important advantages:

- it enables a credible potential purchaser to be presented without revealing its specific identity;
- it can give the names of two executives and their direct telephone numbers to whom potential vendors can respond directly – as virtually all replies to such adverts are by telephone; and
- it enables the adviser to strike up an immediate and constructive dialogue with potential vendors.

The most reliable platform for 'business wanted' advertising is in the *Financial Times* on Tuesdays.

### Dedicated target research

The most productive approach to identifying relevant targets is through the allocation of time, resource and, possibly, professional fees to a dedicated acquisition search exercise. This entails the accumulation and review of as much relevant information as possible on the markets, companies, products and services encompassed by your Acquisition Profile.

Possible sources of information include:

- Kompas product and service information;
- Financial Analysis Made Easy (FAME) CD-Rom;
- Reuters/MAID online information services;
- ICC and Jordans market surveys;
- trade press & yearbooks;
- trade association membership lists; and
- the Internet.

Due to the management time required for a dedicated acquisition search, some acquirers prefer to buy-in the expertise by appointing specialist corporate finance advisers. When doing so, purchasers should:

- only appoint advisers specialising in deals of the size and nature anticipated;
- look for relevant prior sector experience so they do not learn at your expense;
- expect the process to be undertaken by experienced market researchers and not junior corporate finance executives;
- demand exclusivity from your adviser – they should not be acting for anyone else seeking targets that fit your Acquisition Profile; and
- never enter into an open ended monthly or quarterly retainer, as this may incentivise your adviser not to do a deal! The bulk of any fee should only arise from a successful acquisition.

The goal is to identify a short list of, say, ten potential targets that match the Acquisition Profile based upon a comprehensive research exercise. Then to methodically contact each target to open a dialogue with the shareholders before they decide to market the business for sale.

## 4 Making the approach

Hostile takeovers are rare when making unquoted acquisitions. Only very occasionally is a purchaser able to 'make' an owner manager or group sell a business. The process is by definition a consensual one and experienced purchasers recognise that the acquisition process is as much an exercise in seduction and diplomacy when making an unsolicited approach, as it is offering the right price for the target.

### Who should you contact?

Acquirers only have one opportunity to make a favourable impression with the owners of a target. Consequently, making a successful initial approach is crucial.

The initial approach must be made to the key decision-maker responsible for considering a sale. For a private company, this is normally the controlling shareholder, revealed in the annual returns filed at Companies House. With a subsidiary of a group, it is probably the group chief executive or financial director, but not the managing director at the target company, as the approach may not be communicated to the ultimate decision-maker.

If a private company target is backed by a venture capitalist, consider identifying the executive at the institution with responsibility for the specific investment. Before calling the decision-maker, a 'courtesy call' to the investment executive informing him or her you intend to contact the target will generally provoke a positive response. Financial institutions are always receptive to the possibility of making an exit and will no doubt follow up your approach to the target.

### How should you make contact?

Sending a letter to the decision-maker is an unreliable and inadvisable way of making first contact. Successful businesses receive speculative 'mail shot' letters that frequently end up in the wastepaper basket. The most powerful means to make a successful unsolicited approach is by telephone.

The purpose should be to set up a meeting, or better still a lunch, with the decision-maker to discuss your ideas for pursuing mutually attractive opportunities. Before introducing the subject of acquisition or 'merger', rapport needs to be established face-to-face. In the majority of cases, the prospective vendor will not agree to pursue matters there and then.

If not, it is important to maintain the dialogue, perhaps by extending an invitation to visit your premises or agreeing to meet during a forthcoming trade exhibition. Key points to get across are your ability to make an offer quickly, to preserve confidentiality and to be a compatible post-acquisition owner.

Some purchasers are reluctant to disclose their identity until they are confident that the decision-maker is willing to consider a sale in principle. Others are uncomfortable making 'cold call' unsolicited approaches by telephone. Specialist corporate finance advisers can open the dialogue.

## 5 Gathering information

### Initial stage

Once the target company has agreed to explore a deal, the next stage is to gather sufficient information to confirm that it is an attractive company to acquire and to value the business.

Vendors are understandably wary about inviting purchasers to visit their premises for a lengthy meeting, and a nearby hotel room may be more appropriate for information gathering. Nonetheless, it is important to convince the vendors that you need at least to walk through the premises 'anonymously' with them, to get a feel of the operation.

The ground to be covered includes:

- learning about the target's history & development to date;
- exploring the target's products & services;
- understanding the target's markets, customers & suppliers;
- finding out about current year performance & forecast;
- discussing future prospects;
- obtaining information about members of the senior management team; and
- confirming the ownership of the target.

Gaining an insight into the shareholders' reasons for exploring a sale, their personal requirements and anticipated future role is important as it may enable you to structure a more attractive offer (eg. from a tax perspective) without offering a higher price.

Ideally, you should seek to obtain an indication of the shareholders' price expectation as early as possible. However, recognise that canny vendors will decline or only do so once they have taken professional advice.

### Supplementary information

If the rapport with the vendors has progressed during the meeting, there should be a commitment to present an offer fairly quickly. Consequently, it is reasonable to request the following information in order to make the offer as sure-footed as possible:

- two years of audited accounts;
- last year's management accounts;
- latest management accounts for the year to date;
- business plan or forecast for next two years;
- analysis of key customers & suppliers; and
- any 'contingent liabilities' (eg. litigation, warranty claims).

## 6 Making an offer

Having valued the target, the next step is to structure an appropriate offer, obtain the necessary internal approvals and present the offer to the vendor.

### Deal structure

Although most vendors prefer a 'clean' deal based on a single up-front payment at completion, for certain businesses an 'earn-out' or some form of deferred consideration may be appropriate. An earn-out combines the payment of an up-front sum for 100% of the target with a future sum payable contingent on the company achieving certain targets on the basis of a pre-agreed formula.

The following are examples of where earn-outs may be necessary:

- where the business is dependent on key directors and executives (eg. advertising agencies and software businesses);
- where the business is contingent on the retention or renewal of major contracts (eg. facilities management and contract engineering businesses); and/or
- where the business is forecasting a dramatic improvement in financial performance over the following two or three years, resulting in a 'valuation gap' between the target's worth today and in the medium term.

The benefit of an earn-out is to act as 'golden handcuffs' on a vendor, thereby encouraging him or her to stay and develop the business under new ownership, incentivised by the prospect of a further significant sum of money. However, it also means that the target company must be 'ring-fenced' for the duration of the earn-out, thereby potentially preventing a purchaser from integrating the target into another business during the earn-out.

Corporate vendors and financial institutions generally will not accept an earn-out or deferred consideration. Having sold the target business, they have no ability to influence its future performance and therefore no control over achieving the targets set under an earn-out.

### Form of consideration

Often the preferred form of consideration for both purchasers and vendors is cash. However, for specific reasons, the parties may wish to consider forms of 'paper' consideration as an alternative. Two types of 'paper' consideration are:

- Shares  
Some listed groups prefer to issue new shares in their company to vendors instead of cash, because either their shares are highly rated or they have insufficient cash. It is very rare that the vendors of a private company seeking an exit will contemplate accepting shares in another private company as payment. Equally, some large listed groups are reluctant to issue new shares to the vendors of small businesses, even if the vendors are keen to accept shares as payment.

## ■ Loan Notes

A loan note is a type of debt that a purchaser will issue to a vendor as part payment in lieu of cash. Loan notes are often attractive to individual vendors as they may allow the UK capital gains tax liability that arises when selling their shares in the target to be deferred. Although the sale of their original shares may crystallise a gain, the gain is 'rolled over' into the loan note and the tax liability is deferred until the loan note is redeemed by the vendor over a pre-agreed period of time.

The main attractions to a purchaser of loan notes are the reduced up-front cash requirement and, potentially, the ability to offset future contingent liabilities against the loan notes following the acquisition of the target. The disadvantages are the cost of the interest that the acquirer will pay to the vendors over the life of the loan notes, the possible cost of providing a bank guarantee if the vendor insists on one and the additional documentation required.

Loan notes are a widely used form of consideration and purchasers should recognise the tax efficiency for individual shareholders.

## The offer

Offers are best delivered face-to-face in the first instance – not e-mailed, faxed, or posted. By delivering the offer personally, an acquirer can gauge a vendor's response, clarify any uncertainty or misunderstanding and 'finesse' the written offer.

The offer letter should be 'subject to contract' and cover:

- price, normally a range at this stage;
- shares or asset purchase;
- form of consideration;
- deal structure (eg. any earn-out);
- specific conditions attached to the offer; and
- proposed completion date.

The key is to make a tempting but affordable offer, in the light of the face-to-face meeting. Most purchasers do not deliver their best offer at the outset. Acquirers should appreciate that many vendors focus on ability to deliver the offer, speed of completion, tax efficiency and strategic fit as well as price, and these issues should therefore be addressed in a sensitive manner. A positive sign is when a vendor seeks clarification of a written offer.

# 7 Completing the deal

## Negotiating the deal

Having submitted a written offer, the next important step is to seek a formal response from the vendor. There may be areas of the offer or proposed deal structure that can easily be amended to accommodate the vendors. If, having identified the key areas of disagreement between buyer and seller, the gap is not too great to bridge, a meeting should be arranged with the sole purpose of the parties reaching a definitive agreement.

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. The heads should be used by both parties to brief their lawyers and any other advisers to be involved in legally completing the deal.

Heads 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. Depending on the complexity of the deal, this period should be between six and eight weeks.

## Managing due diligence

Due diligence is the process of investigation that a purchaser should undertake on the target company before legal completion. Its function is to confirm the facts and opinions expressed by the vendors prior to a deal being agreed and to identify any trouble spots that were not previously highlighted but that might affect your desire to do the deal, the price you are prepared to pay or the way in which the offer is structured.

The following areas of the target’s business will require careful review:

- past, current and forecast commercial performance;
- past, current and forecast financial performance;
- financial and management controls;
- legal structure and issues;
- property ownership, condition and valuation;
- tax and pensions issues; and
- environmental compliance and past usage issues.

An experienced acquirer purchasing a business in a sector in which it already operates may choose to conduct much of the due diligence using its in-house resources. However, many purchasers appoint external advisers to focus on specific aspects of the proposed acquisition. With up to five or six firms of advisers reviewing parts of the business, it is important for the purchaser or its corporate finance advisers to take a firm grip of the process and proactively manage it.

Typically, the accounting and financial due diligence commences first. The purchaser's lawyers traditionally produce the first draft of the Share Purchase and Sale Agreement. They will generally prefer to have received some initial feedback from the investigating accountants before issuing a first draft so as to make it as specific as possible. It must be realised, however, that some vendors will insist on receiving the first draft before allowing due diligence to commence, in order to flush out contentious issues early. Resist the temptation to delay the involvement of pensions and tax advisers, as it is frequently the slow progress made in these areas that causes unexpected delay at the end of the process.

If the due diligence process identifies fundamental problems within the target business, it is entirely appropriate for the purchaser to negotiate an amended deal. However, before doing so, it is vital that the reasons for renegotiation are valid and well founded. If they are simply a ruse to extract more favourable terms from the vendor, you run the risk of the vendor withdrawing and leaving you with an expensive bill from your advisers.

Legal completion cannot come soon enough for many purchasers and vendors, but it is likely to take at least six weeks from signing Heads of Agreement.

### **Post-acquisition management**

The issue of how a target company is to be managed and, if appropriate, integrated, needs to have been addressed as part of the original strategy. The subject must then be revisited by the purchaser's management team when considering whether or not to make an offer, when structuring the deal and as the results of the due diligence process are unveiled. The time for developing the initial post-acquisition programme for the target company should be between the signing of Heads of Agreement and legal completion, because it is essential that the first day under new ownership is handled effectively.

### **Using corporate finance advice**

Making acquisitions is not only time-consuming but also risky for the unwary or inexperienced purchaser. Many groups see advantages in appointing specialist corporate finance advisers to assist in the following key roles:

- the identification of relevant targets by dedicated research and, if appropriate, advertising;
- making unsolicited approaches and 'door opening' while initially protecting the purchaser's identity, if appropriate;
- valuation, deal structuring and presenting the offer;
- drafting the offer letter and leading the face-to-face negotiations with the vendors and, if relevant, their advisers to produce Heads of Agreement; and
- project managing the whole exercise, particularly the due diligence process.

When selecting advisers, purchasers should ensure that they receive a well-balanced team led from the front by an experienced partner or director. They should always seek client references before making an appointment to confirm the credentials of the lead adviser.

Sector experience and, where considering cross-border acquisitions, an ability to deliver a deal leader with experience in the target's country and a knowledge of the local acquisition etiquette are important.

Fees should be largely success related, with a capped commitment fee paid during the project.



