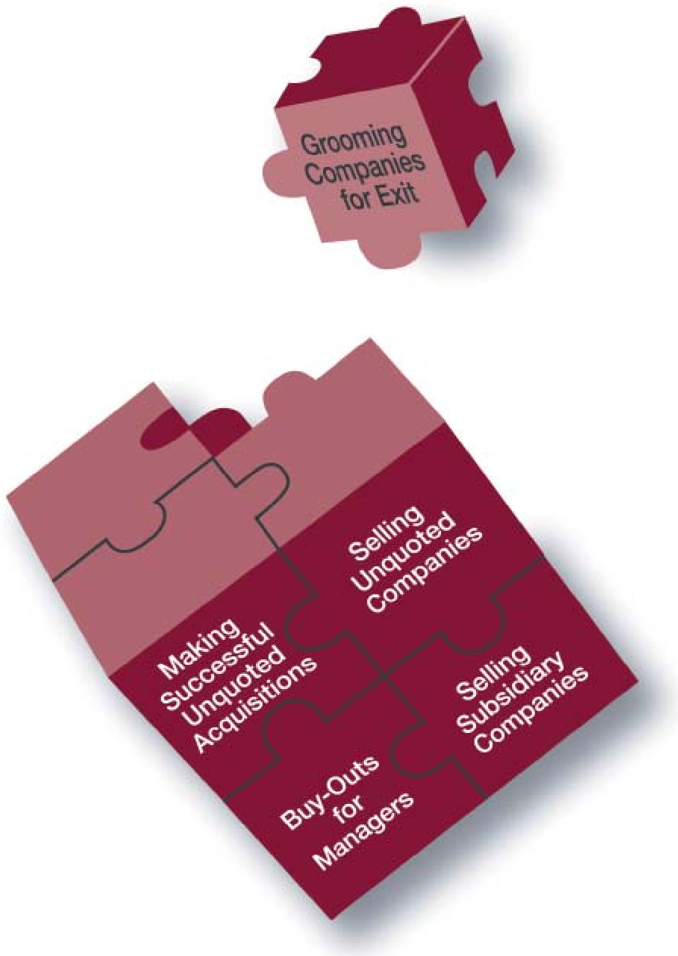
Livingstone



PRACTICAL GUIDE

GROOMING COMPANIES FOR EXIT

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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.

1 Considering an Exit

The Crossroads

There comes a time in the development of every unquoted company when it makes sense for the shareholders to consider how best to fulfil the true potential of their business, while ensuring that they maximise shareholder value and realise a substantial cash sum in the most tax effective way.

This "crossroads" might involve:

- a management team recognising the need to join forces with a strategic partner in order to take their business to the next level;
- the founders of a private company seeking to retire, realise some cash, or resolve a irreconcilable difference;
- an owner manager having no obvious family or other successor to lead the business forward;
- directors and investors seeking to achieve an exit in the years following a management buy-out, buy-in or development capital fund-raising; or
- major groups determining that a subsidiary is non-core following a strategic review of their business portfolio.

In each case, there are a wide variety of exit options open to the shareholders and directors that deserve careful consideration, some of which will be more relevant than others. While thoughts about any exit might be several years ahead, most company owners recognise the value of anticipating and planning for the time when they reach their crossroads.

The Exit Alternatives

The exit routes that most unquoted companies should realistically consider include:

- a sale to either a strategic or financial buyer;
- a management buy-out or buy-in, possibly retaining a minority equity stake;
- a flotation on a stock market, in the UK or abroad;
- an 'equity release' through an injection of external investment or integrated finance; or
- a company buy-back of some share capital.

This guide is designed to help shareholders and directors gauge the right time to consider an exit, to identify the most appropriate exit route, to add value to their business through a structured grooming process in the interim and to ensure that they achieve the best possible deal for themselves, their staff and the company itself.

Appointing Advisers

Most shareholders have a single opportunity to achieve an attractive exit from their business and the likelihood of obtaining the best possible deal may be significantly enhanced by the appointment of specialist advisers with experience of successfully grooming businesses with an exit in mind.

The principal function of any business grooming adviser should be to act as catalyst and collaborator with management to maximise profitability, optimise the business's position within its chosen markets and enhance its ultimate desirability. When selecting advisers, vendors should seek the following:

- access to a team of seasoned advisers which can act as a trusted, confidential sounding board drawing on extensive prior experience;
- a clear and simple grooming methodology which will help to clarify direction, vision and ultimate goals, and then keep the business on track throughout the process;
- a team who can demonstrate experience of working successfully with businesses to implement changes and add-value; and
- the opportunity to obtain personal references by telephoning clients for whom the grooming team leader has worked with.

There is no right time for initiating a grooming process. To obtain maximum value from a formal grooming process, shareholders should consider the appointment of specialist advisers up to two years prior to an exit being sought. However, an experienced adviser can still have a material impact on achievable value as late as three to six months before the exit is initiated.

The private company grooming market is a competitive one and fees are generally comparable amongst advisers. However, your adviser should be able to demonstrate the robust nature of their approach to grooming and a fee structure that is clear, flexible and ideally modular in its format.

Common Business Issues

Every grooming exercise is different; however, the process generally involves three stages:

- NOW? An initial business diagnostic;
- WHERE? Agreeing the ultimate objectives; and
- HOW? Implementing the plan to make things happen.

The most common business issues that shareholders face when contemplating a grooming exercise include:

- a lack of direction, with no clear vision as to where the business is heading;
- the lack of an agreed plan, where management are not pulling together;
- an inability to implement a plan, where management are good at starting new initiatives but seemingly incapable of finishing them;
- the ability to grow turnover without seeing any bottom line benefit;
- the need to access additional skills (e.g. HR, IT, Marketing) without the need to employ full-time specialists;
- a lack of clarity in the sales message, which commonly results in delivering a "Rolls Royce" product or service for a "Ford Mondeo" price; or
- management are in place who are good at what they actually "do" but who are not trained to manage.

A full, frank and honest analysis and diagnostic of the state of the business today is a vital factor when considering the ultimate exit and an important starting point for the grooming process.

Valuation Today

As part of the initial diagnostic, it is clearly important to benchmark both the business's valuation today and set a realistic target value for the shareholders to achieve as a result of grooming.

There is no single correct answer to the question of how much an unquoted company is worth. A number of factors that will affect valuation include:

- the recent, current and forecast profits and cash flow of the company;
- the existence of a visible population of strategic partners, with the appetite to buy;
- the scope for a strategic buyer to derive significant synergistic benefits;
- the scarcity value of the company and its market position; and
- the value being placed on comparable unquoted and quoted companies in the sector.

An independent valuation may at best provide an important comfort level for shareholders who are uncertain of the likely achievable value of their company. At worst, it may provide a necessary spur for those with a high price aspiration to focus on building shareholder value.

In the context of a trade sale, the true value of any company is not what the shareholders or even a single purchaser thinks that it is worth; rather it is the most attractive offer received from several serious purchasers. If the shareholders can create a competitive bidding situation, the highest offer received is likely to be significantly higher than the lower, frequently 50% higher. Nevertheless, it is useful at the beginning of the grooming process to apply some broadly adhered to valuation principles to benchmark the business valuation today.

2 Adding Value Through Grooming

The Grooming Process

It is vitally important that any business grooming process adopts a considered and clearly-structured approach, based on a detailed understanding of the business and a collaborative assessment of its strengths, weaknesses and future potential. This may manifest itself in a five-step programme:

Step One (Shareholders Plan):	build an agreed "big picture strategy" over the life of the grooming period (see below);
Step Two (Action Plan):	drill down into detail with management to identify and deliver the "value drivers" (see below);
Step Three (Business Structure):	focus on the company's structure to optimise the shareholders tax position, as well as the activity structure (to maximise the business' profit potential);
Step Four (People Structure):	focus the key managers on achieving their objectives in the context of the grooming process; together with how we are motivating them to achieve results; and
Step Five (Implementation Plan):	a rigorous follow-up process aimed at quickly identifying where the plan may be in need of further attention and refinement.

The grooming process should be one that drives business direction, locks strategy into place, ensures implementation through focusing and incentivising management and keeps it on track throughout the grooming timescale.

The time and resources devoted to each of the above steps will clearly differ with the size and sophistication of the business concerned. However, in all cases, shareholders, management and adviser must work closely together to achieve the maximum benefits.

The Shareholders' Plan

Step One in the grooming process should be designed to:

- understand and review the business's current situation and future prospects;
- identify the priorities, goals and timescales of the shareholders;
- impartially evaluate all possible exit routes and the tax implications;
- select a preferred exit route, process and timing;
- agree the optimal shape of the business to achieve that exit route;
- identify any obstacles or conflicts which could frustrate or delay the exit; and
- agree a "big picture" action plan to maximise value and overcome obstacles prior to exiting.

Building Value – A Five Step Route Plan

Ultimate destination?	'Big Picture' Strategy	Shareholders' Plan: – Destination – Timescale – Goals – Vision – Management Issues
Route to get there?	Action Plan	Management's Plan: – Strategies identified – Priorities agreed – Management "buy-in" – Team accountability
Vehicle for the trip?	Structure	Business Structure: – Tax structure – 'Non-core' assets – Activities structure
Passengers comfortable?	People	People Structure: – Roles – Define success – Motivate – Measure – Reward
Fine tuning?	Detailed Implementation	Implementation plan: – Making it happen – Continual improvement – Test desire

Out of this process, a series of conclusions should emerge regarding the most appropriate route forward. This should be discussed, rehearsed and agreed with all of the shareholders prior to moving into the specific business improvement process.

To make a substantial difference to the ultimate value of the business, shareholders should consider undertaking this exit strategy review approximately two years before actually initiating the exit process.

The Action Plan

The principal objective of the grooming process should be to help shareholders to build a business that is capable of achieving the chosen exit route within the preferred timescale on the best available terms. For unquoted companies, this normally means shaping the business to look like one that a purchaser will want to pay a premium price to acquire.

By determining those characteristics that a potential purchaser, private equity house or stock market investor will prize most highly at the point in which the exit is initiated, it is possible to pinpoint the potential changes to be made to the existing business during the grooming period.

Some business changes will result in quicker or more tangible improvements in value than others, particularly when assessed in the light of constraints of timescale, investment or available management resource. The most valuable potential changes are commonly known as the "value drivers". These include the following:

- a clear upward trend of profits, as it is important to demonstrate a steady and sustainable year on year increase in profits;
- a tightly controlled business, actively implementing opportunities for cost reduction that will not damage the well-being of the business;
- a focus on winning a wider range of particularly "attractive" types of customer;
- ensuring that product or service ranges offered will be marketable going forwards, focusing on the pipeline of innovative new offerings;
- a detailed understanding the factors that are driving value in your particular market;
- building the brand image and market profile that you should ideally be projecting;
- working with your management team to ensure that they are ready to face new challenges with new owners; and
- ensuring that the company's statutory and tax affairs are in order.

By prioritising the above, or alternative value drivers relevant to the specific business, the shareholders can ensure that time and energy is focused where the returns will be greatest.

A careful balance should always be struck between achieving the shareholders' goals and the meeting the needs of the business itself. While the best grooming programmes result in a better all-round business, the implementation of short-term measures with potentially detrimental consequences in the medium- to long-term needs to be carefully considered – and ideally avoided. There is clearly less likelihood of being confronted with such difficult decisions where the grooming process is being implemented over a period of several years.

Business Structure

There are three important aspects with regard to business structure and the grooming process:

- optimising the shareholders' tax position upon an exit;
- extracting tax effectively any surplus (e.g. property) or 'non-core' assets that can attract a separate value from the company; and
- maximising the business' profit potential through a structure which ensures both "value" and "efficiency".

The effectiveness of the shareholders' tax structuring frequently has the potential to either "make or break" a deal. An experienced tax adviser will seek to:

- always remember that the overall objective is to make a deal happen – overly "creative" tax planning can unintentionally create serious obstacles;
- attend to "tax housekeeping" to ensure that simple compliance issues or planning steps are not overlooked;
- focus much of its attention on optimising the structure with specific regard to Business Asset Taper Relief (several years in advance of an exit); and
- ensure that post-exit tax consequences of a disposal are dealt with effectively.

Most businesses outside the property sector are valued on their profitability or cash generation. It is not uncommon however, to find successful private companies with a disproportionately high level of net assets compared to their profitability or cashflow. In such cases, it is often sensible to consider extracting any 'surplus' assets (eg. freehold property with development potential) in order to maximise shareholder value and remove a potential obstacle to a deal.

However, structure is not solely focused on tax and surplus or 'non-core' assets. A grooming adviser will equally be aware of the structural aspects of the business in maximising profitability and business desirability.

Clearly timescale is an important consideration here. It would probably not be appropriate to seek to materially alter a business's existing structure where the life of the grooming process is relatively short (less than 18 months). However, where time allows, such considerations can have a huge impact on value.

There are generally four fundamental aspects to any business structure:

- how the business is structured to win new customers;
- how the business is structured to manage and retain customers and maximise their sales potential;
- how the business is structured to harness those intangible factors (such as knowledge, experience, creativity, design) in "selling the dream" to customers (solving their problems in principle); and
- how the business is structured to efficiently and effectively "deliver the goods" (solve their problem in fact).

Businesses are frequently not structured so as to maximise "value" or "efficiency". The extent that it is possible to do so will often determine the ability of the business to maximise its profits and/or its desirability. The grooming process should identify those fundamental changes or fine-tuning adjustments that can deliver greatest value or efficiency.

The importance of capturing the "intangibles" should not be under-estimated. It will commonly be in such areas that potential purchasers and investors perceive greatest opportunity, yet the business may not yet be structured so as to deliver them post-exit. This is particularly relevant where the exiting shareholders are a fundamental driver within the existing business structure.

People Structure

The most common issue for privately owned companies is the need for the owner managers to have made their business less dependent upon their own involvement. The greater their success in achieving this goal, the more likely that a new investor or purchaser for the company will be comfortable with the shareholders making a clean and quick financial and management exit.

In particular, this means:

- promoting the emergence of a clear successor as Managing Director, with a strategic vision for the business (shared by the team);
- building a balanced middle management team that is demonstrably capable of running the business on a day-to-day basis;
- a measured transfer of key customer and supplier relationships from the founders to the management team; and
- installing a professional accounting and financial infrastructure providing easy access to accurate data on the business.

This gradual transfer of responsibilities must be real rather than purely cosmetic. However, an experienced grooming adviser will be sensitive to the discomfort that many owner managers feel when faced with handing over the running of their "baby".

Where changes in the incumbent management team need to be made, an adviser can act as an important 'buffer' between the shareholders and the remaining managers, as well as a useful resource for creating appropriate job specifications and sharing the executive selection burden.

Many well-established businesses already have a proven management team in place. In this case, the operational grooming issues may be less evident but other problems can emerge which will need careful thought. For example, a management team may have aspirations for mounting a buy-out of the company, thereby putting them in potential conflict with the shareholders' goal of maximising value in due course.

In any event, shareholders should recognise the importance of motivating their management teams to work tirelessly on their behalf. This may result in the need for meaningful financial incentives to be put in place for key managers, so aligning them with the shareholders' goals.

Working in Partnership to Build Value

Shareholders should always commit to a rigorous follow-up process to ensure that agreed grooming actions are being successfully implemented. In this respect, the involvement of an external facilitator can play a key role to ensure that momentum is sustained throughout the countdown to exit.

If the implementation process is not followed up, the shareholders can expect to see some recurring themes. In any management team there will be a mixed appetite for addressing the priorities and actions agreed in Stages One and Two. In addition, team members will range in personality from the "enthusiast" to the "cynic".

An effective process will ensure that actions are properly followed through and that the "enthusiast" will enjoy and benefit from their efforts. If actions are not adequately pursued, the "cynic" may well prevail and the management team as a whole may become demoralised.

A rigorous approach must be applied to ensure that the momentum behind business improvement is maintained so that:

- all the necessary facets of a coherent change management process are in place (vision, plan and desire to implement);
- grooming is not seen as a "one-off" fix but as part of a continual improvement process, focused on exit;
- priorities are addressed – and refined in the context of a changing market environment – through the "value drivers" principles;
- management are intimately involved, have ownership of the action plan and are accountable for its achievement – and are suitably motivated to succeed; and
- the personal exit aspirations of shareholders are always balanced with the needs of the business to continue to develop.

This final point is particularly important in most private companies and is surprisingly often overlooked. What are the lifestyle aspirations of the shareholders post-exit? How will that lifestyle be funded? It is fundamental that shareholders should apply personal financial planning with as much rigour as they do for business planning. Clearly this is a subject that can and should be run in parallel with the business grooming process.

3 Initiating the Exit Process

Get Your Timing Right

When considering the timing of an exit, shareholders should take into account the time required to initiate and complete the exit process, as well as the frequent need for them to retain a management or financial involvement with the business post-deal. A sale of a company or a flotation will generally take between six and seven months to complete from the shareholders deciding to initiate the exit. Both exit routes must of course be considered in the light of prevailing market conditions, particularly in the case of a float where market volatility may cause delays.

In the case of a trade sale, strategic purchasers frequently regard management as a key component of any deal and therefore look for a period of continuity with the incumbent team staying in place after the deal. This may involve anything from a simple 'hand-over' period of six months to a two or three year contractual commitment for key owner managers to stay in place linked to an "earn-out" capable of delivering further shareholder value.

While flotations are often regarded as an exit route, in truth they rarely provide owner managers with an exit for more than 10% of their existing shareholding at the time of the float itself, as prospective City investors always look for an ongoing commitment from the existing shareholders. Following the float, the ability of the original shareholders to sell further shares in the market may be limited for up to 18 months and, subsequently, may be limited by the regular 'close' periods under which directors are limited from dealing in their company's shares in particular reporting periods.

Taking into account both the exit process and possible post-deal commitments, it may be as long as two to three years following the commencement of the exit process before certain shareholders have achieved a 100% exit from the business.

For a 45 year-old entrepreneur seeking to groom and exit his or her business before the age of 50, the time to consider appointing advisers is now!

Making Acquisitions

Grooming programmes with a longer-term horizon may well incorporate selective acquisitions as a means of securing new skills, channels to market or simply critical mass. It is important to bear in mind that acquisitions are complicated, time consuming and may dramatically change the risk profile of the vendor business in the eyes of prospective buyers.

Shareholders considering acquisitions should therefore accept the need to integrate the target business and for the strategic or synergistic benefits to be manifesting themselves in both top line sales and bottom line profit before initiating their own exit plans. Where a recent acquisition remains 'undigested' and therefore unproven, potential strategic partners or investors for the enlarged group may view it as a more risky proposition and therefore discount value.

4 Maximising Shareholder Value with Livingstone

The decision to structure an exit from a business is a major milestone in the evolution of every successful business. Having handled the sale or acquisition of over 400 companies in the last 16 years, the Livingstone team has an intimate understanding of the challenges of grooming a business for sale, identifying value drivers and tailoring and implementing an exit process that delivers clarity, certainty and maximum value for our clients.

Most of our client relationships commence several years before a sale process is actively pursued and we welcome the opportunity to offer advice to management and shareholders from the very beginning of their thought processes, even though a transaction may still be some way off.

To assist in the grooming process, Livingstone has assembled a growing team of industry advisers with hands-on experience of building, grooming and exiting their own businesses – in certain cases, several times over – as well as going on to manage major international groups. We regularly call upon these experienced operational managers to assist our clients in the development and execution of detailed grooming programmes.

Where we do not have a suitable industry adviser, we have built relationships with several specialist grooming advisers, who are excellently positioned to offer practical and cost-effective advice to directors and shareholders as part of a seamless grooming process with Livingstone.

If you would like to explore how we can help you to maximise the value of your business, please contact Ann Wilson in strictest confidence on 020 7484 4727. All discussions will be held in strictest confidence and at no initial cost or any sense of obligation by you.

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