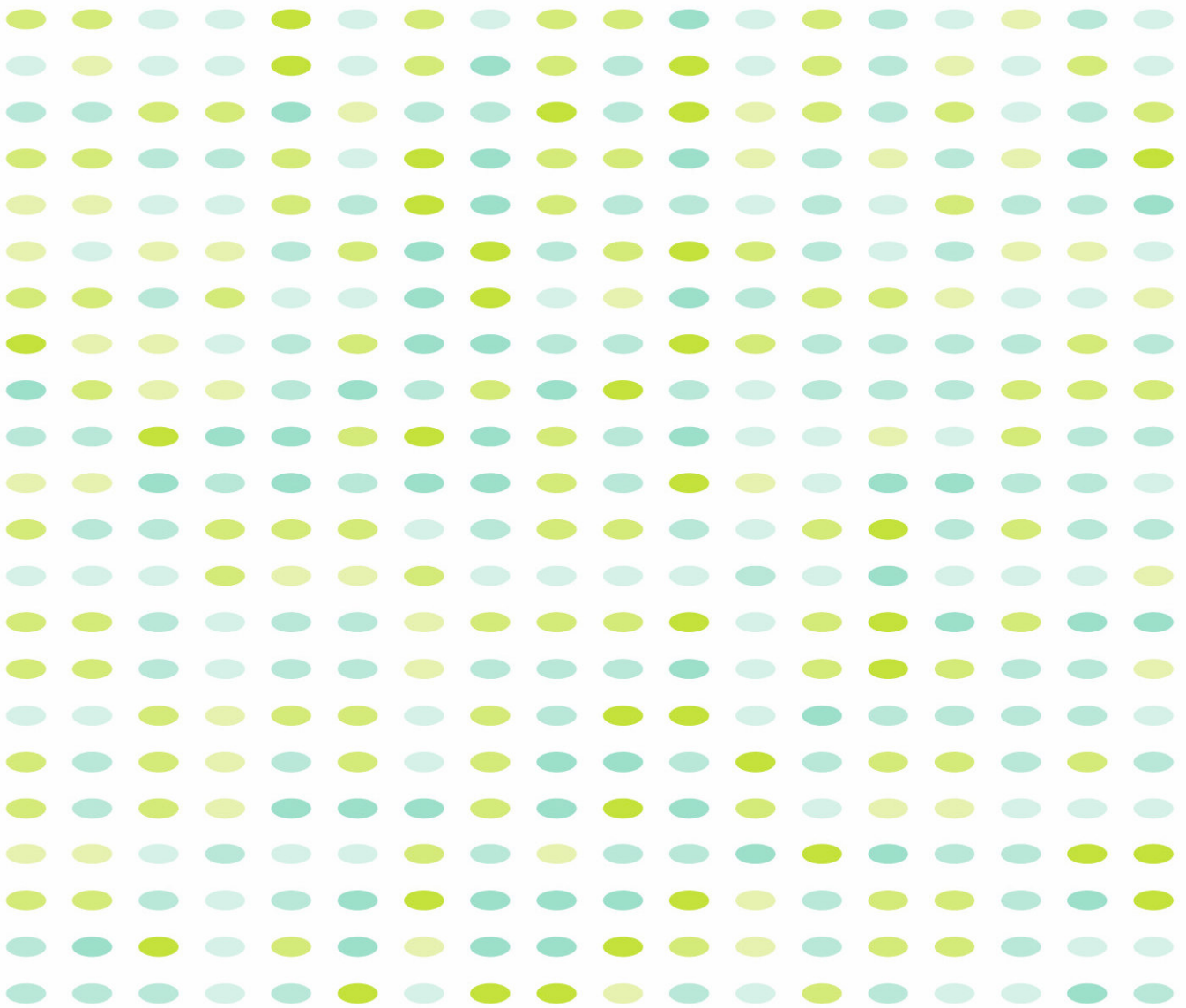


The SWAIN guide to Exits



In conjunction with:

Bond Pearce

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The South West Angel and Investor Network (SWAIN) connects private investors or “Business Angels” with companies looking for investments. SWAIN specializes in helping small and medium sized companies to find equity finance, and assists private investors in the South West to search for investment opportunities in businesses with growth potential.

Selling all or part of your business may be the most important financial deal you will ever undertake, or one of a series of successful investment realisations. This guide gives an overview of the exit process from the point of view of existing shareholders selling their interest. It applies equally to founder entrepreneurs and business angels, although the latter will have particular tax and strategic goals and time lines which are unique to them.

Why exit?

Shareholders make an exit from a company for many different reasons. In some cases the sale is forced upon the owners of a business because the business is failing or other financial pressures mean they need to realise their investment. More often than not, however, an exit is undertaken at a time when it is not essential. The difference between a distress sale and a voluntary exit is significant and affects everything from the range of likely buyers to the valuation and timetable.

Shareholders who are closely involved in the management of their companies (known as owner managed businesses or OMBs) often wish to exit their companies when they reach a certain age or stage in their lives. Effectively these are retirement sales and it is important to plan for such sales to ensure that the value of the business can be realised in the absence of the founder/owner. See “grooming” below.

Business Angels invest with a view to making their return on investment over a much shorter time period than the typical entrepreneur or owner of a lifestyle business. They are not involved in the day-to-day management or doing the work of the business in an executive capacity and their primary motivation is to make money from their investment. Whilst some investments in a profitable company can deliver yearly income to shareholders by way of dividends and direct bonuses, it is usually the

capital exit that delivers the desired return on investment (ROI).

Some exits are desirable from a strategic point of view where, for example, a small growing business can accelerate its global impact by being bought by a much larger player. Other exits are purely to realise capital for personal or business reasons such as to use the money raised to pursue other opportunities.

The different exit routes

The usual routes by which a shareholder can sell all or part of their investment in a company are as follows:-

- Trade Sale
- Management buy out
- Management buy in
- Family succession
- Flotation
- Liquidation

Trade sale

A trade sale is usually the best way to achieve a successful exit from a profitable company and the majority of exits occur in this way. It is not uncommon for OMBs to have a reasonably good idea of who the likely buyers for their business are – indeed they may have received unsolicited approaches already. Trade buyers are often looking to increase market share by acquiring a competitor, increase profitability by increasing sales using existing overheads or

extend product ranges by the acquisition of companies with unique brands or intellectual property.

Management buy outs (MBO)

A sound management team that can carry a business forward after the exit of key founder figures is an important asset to any company. The management of a company knows its potential and pitfalls better than anyone else and it is often worth establishing whether management has the appetite and financial muscle (or borrowing ability) to buy the company from its existing shareholders. Consider allowing management to acquire the business in stages over time, retaining your share of profits if you do not need a complete exit. Although MBO teams sometimes find it difficult to match the cash available to trade buyers and usually need a complex financing package to complete their offer, it is often a good idea to keep an MBO available throughout an exit process as an alternative to a trade sale.

Management buy in (MBI)

Under a management buy in (MBI) an external management team, typically funded by a venture capital firm (VC) buys the business and replaces some or all of the existing management team. This is similar to a trade sale where existing management are replaced by the trade buyer, but is generally driven by the key individuals in the management team looking to create a transaction and value for themselves and their investors. MBI teams rarely invest the majority of the money required to purchase the business and therefore need to achieve a return for their investors (possibly by way of a subsequent exit) as well as themselves.

Family succession

Many successful companies have passed from generation to generation successfully with each "new broom" building on the foundations laid down by the former. It is, however, rare to find that a family's own members are genuinely the most capable management team to take on a company or maximise its potential and it is very rare for an exiting shareholder to achieve maximum value where the company is being "sold" to family members. In family transfers, of course, money is not everything. There are some benefits from a family succession in terms of continuity, particularly for staff and, if amicable, the process can be relatively pain

free in terms of the legal documentation and risk apportionment.

Flotation

Nearly 1800 companies are currently listed on the Alternative Investment Market (AIM) and other markets such as Plus and Sharemark can also provide a public market on which to sell shares in a company. It is unusual for a flotation to achieve a full exit for a shareholder who has founded a company or is important to its success, although institutional investors and Business Angels may be able to exit completely on an initial public offering (IPO) if new investors in the company are willing to see their investment used to pay out existing shareholders rather than fund the expansion of the business.

It is surprising how few companies based in the South West are listed on a stock market. Although the process can be expensive and take several months a flotation can achieve many things that the other forms of exit cannot, including for those who use it to effect a partial exit and keep a retained investment in a valuable listed entity with the ability to grow further using shares as its acquisition currency. Further information on preparing a company for a flotation on AIM or other stock markets is available from Bond Pearce upon request.

Liquidation

This may be the only option if you cannot find a buyer willing to purchase the company as a trading business. It is not essential for a company be in distress for it to be liquidated, although the value attributable to the company once it has ceased trading on an assets only basis rarely equals the "sum of the parts" of a successful profitable company. It is sometimes the case, however, that the net assets in a business are collectively worth a significant sum of money and buyers are willing to buy those individual assets free of any ongoing trade. The process of selling a company which is in distress or insolvent is beyond the scope of this guide, but will typically be dealt with by an external insolvency professional appointed by the bank or other creditors to realise assets.

The exit process

Although there are many aspects to the exit processes listed above which are unique to them, most exits need to go through some or all of the following milestones:-

- Grooming
- Appointment of advisers
- Preparation of information memorandum
- Finding buyers
- Negotiating a deal
- Completing the deal
- Post completion liabilities and restrictions

Grooming

Many business owners will be aware of the concept of “grooming a business for sale”. It is important to realise that “grooming” goes way beyond making cosmetic adjustments to the appearance of a company prior to its sale. All buyers are interested in key elements of the business which go to the core of its value, and “grooming” is designed to solidify and enhance these aspects to achieve an optimal valuation. For example:

- Showing consistent or growing profitability
- Securing intellectual property
- Having a diverse client/customer base
- Showing a careful control of costs
- Having good management/succession plans
- Organising the sale entity effectively (by, for example, separating business and property assets)
- Quality of property and other assets.
- Quality financial and management information

Appointment of advisers

Most companies will have an accountant and may have a solicitor for day to day legal matters. A significant exit for a company is a transaction which requires specialist advice, and it is quite common for historic company advisers to be replaced by corporate finance specialists if an exit is being planned. Most exits require a corporate finance accountant and corporate finance solicitor. In some cases a separate corporate finance adviser is appointed to assist with the identification of buyers and negotiations. All advisers would say that they are able to be most effective when they are involved in a potential exit from the earliest possible stage – not all will

start charging for their services until a transaction is actually happening.

Preparation of Information Memorandum

In most cases where a business is being prepared for sale to a yet to be identified buyer a pack of information about the company called an information memorandum (IM) or sales pack is prepared. This is usually prepared by the company itself with input from the corporate finance accountant/adviser and solicitor. IMs follow a fairly standard format and buyers expect to see certain information about the company to allow them to decide whether or not to proceed. The extent to which the IM contains confidential information about a company is always a point for discussion – too little information will not give buyers enough information to go on, but on the other hand sellers are always loathe to give third parties and especially their competitors any real data about the business. Confidentiality agreements or non disclosure agreements (NDAs) are required to be signed before confidential information is disclosed to potential buyers, but these are rarely sufficient to prevent the gain being made from a competitor simply fishing for information when another company comes up for sale

Finding buyers

Even where a company has received an unsolicited approach from a trade buyer or individual, it is usually recommended to establish whether there are other potential buyers willing to pay more for the business or offer a more attractive package. In some cases a formal “auction” process is established by the corporate finance lawyer or accountant whereby the identification of potential buyers is carried out, NDAs are issued to those interested buyers and a process whereby “best offers” can be submitted is carried out. In an ideal world there will always be more than one potential buyer for a company (see above in relation to a potential MBO alternative), although it is usual to go into an exclusivity period with the preferred bidder to allow them the time to investigate the due diligence material available on the company and to negotiate the legal documentation without continuing interference from another possible buyer

Negotiating a deal

It is usual for the basic terms of an exit deal to be captured in a letter of intent (LOI) or heads of agreement. These are usually not legally binding, save for provisions relating to confidentiality, the exclusivity period and, in some cases, provisions dealing with contributions towards the costs incurred by the other party if one party withdraws in certain circumstances. We would always recommend heads of terms to deal with some of the key negotiating points that typically come up later in the transaction at the outset – although not legally binding, heads of terms carry significant commercial/moral weight and it is a good idea to identify commercial “deal breakers” at the outset before the significant costs incurred in completing a transaction start in earnest. The actual process of negotiating the transaction is covered under the section headed “The Legal Process” below. Once heads of terms are signed there is still a long way to go – around 50% of transactions do not proceed beyond the heads of terms stage for various reasons, such as problems revealed during due diligence, funding problems or deal-breaking issues on the legal paperwork.

Completing the deal

The point at which the interest in the company is sold by the exiting shareholders is called “completion”. This is usually the point at which the money paid by the buyer is handed over, subject to deferred payment or post-completion accounts being prepared to accurately show the value of certain assets. Completion is the point at which the ownership of the company has legally transferred.

Post completion liabilities and restrictions

In some transactions there is a period after completion when existing management or owners of OMBs are required to stay on to effect a handover or operate in a consultancy capacity to ensure the buyer gets the full value of the company/asset he has bought. Earn outs and other deferred payment mechanisms also entail ongoing legal obligations post-completion. In addition, it is usual for buyers of a company to insist that certain sellers are restricted from competing with the business that they have just sold – typical non-compete periods for shareholders are 2-5 years and the precise scope of the restrictive covenant needs to be carefully negotiated if an exiting shareholder wishes to re-invest the sale

proceeds in another business which is any way similar to the business that has just been sold.

The legal process

The main concern for the seller, apart from the obvious objective of maximising the price, will be to achieve the sale in the most tax efficient manner while minimising financial risk under the acquisition agreement. The buyer will have a different perspective on the transaction in that he will need to assess that he is paying the right price, and he will seek protection from unforeseen liabilities and reassurance that the target company is in fact as it appears.

The sale process can be split into three principal stages, all of which are interrelated.

Due diligence

The buyer will usually carry out a thorough investigation of the company or business in order to find out as much as possible about its affairs. The buyer's lawyers will prepare a due diligence questionnaire which contains a list of information seeking questions addressed to the seller by his lawyers. The questions are usually extensive and will cover the whole range of the target company's business, its status and the ability of the seller to transfer the shares.

Acquisition agreement

This agreement is the key document for the sale and purchase of the company or business and it is standard practice for it to be drafted by the buyer's lawyers. It is normally a lengthy document and up to half of the agreement can be devoted to the warranties. The reason for this is that when a buyer acquires a company, he takes over not only all the company's assets but also its past and future liabilities. Even on a business and asset sale (as opposed to a share sale) extensive warranties are usually required. Warranties are a way of providing the buyer with some contractual protection against these liabilities.

The main body of the agreement will usually include:

- an obligation to buy and sell the shares (or assets) at a specified price and any provisions relating to the method of calculating the purchase price;

- the precise steps to be undertaken at completion of the sale. Many of these are formalities relating to the change of ownership of the target company (or assets);
- a clause dealing with the warranties which is supplemented by a separate schedule setting them out;
- a clause setting out the certain limitations on the seller's liability under the warranties; and
- restrictive covenants imposed on the seller and/or key personnel to prevent them from competing for the target company's business.

There are usually a number of schedules to the agreement which cover matters such as details of the target company and any other companies within the target group; details of the seller; the target company's properties etc. Further schedules may also be included which deal with specific issues too bulky to be dealt with in the main body of the agreement. For example, protection against tax liabilities is commonly set out in a schedule known as the tax deed.

Disclosure exercise

The seller limits his exposure under the warranties by means of a document called the disclosure letter. If a warranted fact turns out to be untrue the buyer has a claim for breach of contract regardless of whether he relied on the warranty in question. No claim will exist, however, if the facts which give rise to the breach were set out in the disclosure letter. The letter is drafted by the seller's solicitors but will be addressed to the buyer from the seller and is usually divided into two parts: general disclosures which are general matters about the business and assets, and specific disclosures which specifically disclose actual matters which, if not disclosed, would constitute a breach of warranty.

In reality, the whole of the sale process outlined above amounts to an exercise in risk allocation against a background of current usual practice. The process from signed Heads of Terms to completion usually takes 6-8 weeks.

Tax

The important question for an exiting shareholder is not the total consideration payable for their company but the amount of the sale price which they will eventually end up receiving, and when. Elements such as deferred consideration and earn out mechanisms and the risk of having to pay back money due to valid warranty claims are one element of this, however careful tax planning is another key factor in maximising the "net" exit value from a company.

Different exit structures have different tax consequences. At the most basic level, a share sale has a different tax impact than an asset sale by the company because on an asset sale the company is taxed on the sale of the assets and then the shareholder is taxed again when the proceeds of the sale of the assets are passed up "through" the company to him. For this reason share sales are most popular with selling shareholders, whereas buyers are often keen to buy only assets because this allows them to pick and choose the assets and liabilities they take on rather than the comprehensive range of assets and liabilities that comes with a share acquisition.

Currently (until 5 April 2008) most shareholders in unquoted companies are eligible under 'taper relief' for a very attractive tax rate (frequently as low as 10%) provided the shares have been held for two years. However, taper relief is not straightforward and the position is even more complex if employee shares or share options are involved.

However, it is difficult at present for a shareholder to be certain of the tax consequences if he sells after 5 April 2008. The Chancellor's Pre-Budget Report proposes that from that date taper relief will be scrapped and all capital gains will be taxed at 18%. This increase in rate for most sales of unquoted shares is being strongly resisted: the position is unlikely to become clear before the end of the year. Specialist advice is definitely needed at an early stage, whether the intention is to sell before or after 5 April 2008 or indeed to decide whether a sale should be brought forward to pre-5 April 2008.

Top tips for a successful exit

- Do your preparation thoroughly
- Iron out wrinkles beforehand and make sure your accounts and records are up to date
- Show you have a strong succession plan
- Do your tax planning
- Keep an open mind on deal structures
- Timing is everything
- Incentivise management (by way of share options or a bonus on sale) to help in the process
- Explore MBO and IPO possibilities
- Seek professional advice early on
- Know your bottom line
- Be prepared for staff unease
- Don't forget to run the business

Bond Pearce resources

Bond Pearce has published Guidance Notes for Business Sales and Guidance Notes for Share Sales which are available on request from Richard Cobb (richard.cobb@bondpearce.com) or by calling 0845 415 5230. We are always willing to have a free initial meeting with any companies that are looking to achieve an exit. In each of the last three years Bond Pearce has acted on more significant corporate finance transactions in the South West than any other firm, which gives us a perspective and depth of experience of corporate finance transactions which is second to none in the region.

www.swain.org.uk

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