the cfo centre

HEADING FOR A BIG EXIT

Why does one company sell for more than another?

Why does one company sell more quickly than another?

“My part-time CFO Centre CFO has added at least $2 million to the sale price of my business.”

Matthew Byrne. CEO. DBI Group

Introduction

Most of us have bought or sold a house and understand that many different factors come into play to determine the price we have to pay.

We are attracted by the size of the house, its location, the proximity to schools/restaurants/work and are possibly concerned about the purchase price, a higher mortgage, increased running costs and what a survey might reveal.

It should be no surprise then that a business purchaser will also have to balance the excitement and ambition of expanding his or her existing business with the cost of acquiring it, the availability of finance, future profitability and unexpected liabilities.

The key to maximising value is therefore to make your business as attractive as possible to potential purchasers and, once found, ensure that there are no surprises or disappointments that could lead to a change of heart on the purchase price, cause extra conditions to be placed on the purchase or lead to the sale falling through.

The price paid for a business is often quoted as a multiple of historical profits. As a purchaser is buying the expectation of future profits the multiple will tend to be higher in fast-growing industries and fast growth companies in those industries. It is why many businesses move from low value added buy/sell business models into higher value added consulting/services models where the profitability and opportunities to grow are better.

There are many advisers around who will claim to be able to sell your business for the maximum price. You need to be able to select one that actually has the credentials in your industry, in your markets and in your size of business to work with you over a period of months or years to achieve your goals. The right choice should maximise what is important to you, be it price, post-tax cash, the future of your staff, the continuation of the values of the business. The wrong choice could end up losing a sale and wasting a lot of time and emotional energy that could even blight the business for a few years if handled wrongly. The house sale analogy is relevant here. We can help with the information and introductions to make the correct choice for you.

This paper concentrates on what is required, primarily from a financial point of view, for an exit. It assumes that you have your strategy in place to achieve your objectives, the choice of advisors and the sale process itself are outside the scope of this paper.

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Planning an exit

Much of exit planning is actually implementing good business practice. As a business owner you will exit at some time, hopefully on your own terms at a time of your choosing.

To achieve that it is necessary to plan ahead to ensure that the business you are selling or passing on is in good shape to generate future profits for your successor and that as much as possible of those profits remains in the business to be distributed to its owners and employees rather than paid in taxes.

It is an often quoted truism that you sell a business when someone wants to buy, not necessarily when you want to sell. If the dream buyer turns up with an unsolicited offer tomorrow would you be in a position to maximise that opportunity? Probably not, but forward planning would make life a lot easier should that call come. When a sale takes place it is often the finance team that is placed under most pressure due to the need to prepare documents and analyses. It is therefore the finance team that is best placed to help you plan in advance.

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Ownership, shares, options

Starting with the basics, who owns the business? The simplest structure is for all shares to be owned by one person who makes all the decisions and receives all dividends and payments (after tax) for selling the business.

If you have more than one shareholder do you have a Shareholders' Agreement? An agreement should cover the relationship between the shareholders and, importantly should an exit arise, what happens if there is not unanimous agreement on the terms of an exit. It will also include the procedures to be followed, valuation method and the potential next owner of any shares should the ultimate exit, the death or critical illness of a shareholder occur.

Are there others who are expecting to become shareholders, perhaps have been promised that they will be? Would it make commercial sense to reward some members of management with shares or options so that they have an incentive to help add value to the business and remain with it? New shares or options will require a valuation of the business which may also need expert tax advice if you are going to take advantage of a tax-saving scheme for options. The basics of option schemes have stayed the same for some time but the detailed rules change in most budgets so it is wise to get professional advice before implementing a scheme.

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Property

Property can be a major sticking point for a purchaser. Assume that it is going to be regarded by them as large liability which will be a drain on the benefits they are planning on for their business after the acquisition.

Who owns the property? Is it the company, you the business owner, your pension scheme or a third party landlord?

If the company owns the property has it been valued recently and is that value reflected in the balance sheet? If a buyer is interested in the property then it is better to have a valuation available to include in the accounts rather than have the discussion when sale negotiations have already started. That said, unless the premises are critical to the business and it has to be included in a sale of the business many buyers do not want to take on freehold property and you will need to consider how you might dispose of it or lease it to another user going forward.

It is worth considering whether to transfer ownership of the property to your superannuation fund, many SMSFs allow this, or to yourself or a family member. The property can then be used by the company on a commercial lease. As with any property transfer there are complications, primarily the interaction of a number of state and Federal Taxes, that require proper advice sooner rather than later.

A lease will be treated the same way by a purchaser, regardless of the owner. It is, in their eyes, a commitment spread over several years that could be difficult to get out of. Clearly, you need to continue running your business and need some security of tenure but is ten-year lease with upward only rent reviews the right thing to enter into when you might be wanting to sell within three years?

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Intellectual property

Where intellectual property ("IP") is obvious – physical inventions such as the ubiquitous better mousetrap – most businesses will have registered patents and/or trademarks to protect the unauthorised use of their IP.

Have you considered what you have developed over time in your business, be it a product, process or brand, that might be capable of being protected and would be worth spending time and money on to protect? Buyers are buying the future profits of a business, they need to know that if that business relies on particular IP to continue to trade that the IP is protected and the trade will not be undermined by a competitor who can copy the IP and produce in competition, possibly more cheaply or in greater volumes.

Even if protection is not appropriate perhaps there are tax breaks or grants available to develop products or processes further. The hurdle for obtaining R&D tax credits is lower than what is needed for most grant applications so may be worth investigating – with a professional adviser of course.

Contracts

Do you have formal contracts or Terms and Conditions with all your suppliers and customers? If so, have they been reviewed for any legislative changes? Do you know what happens if you sell, can the contract be novated by the other party (will it remain in place after a change of owner)?

It is another case of the buyer gaining confidence that the business will continue to enjoy at least the same terms of sale and purchase post-acquisition.

On a similar theme, are there any significant customers or suppliers (over 20% of sales or purchases) and how might they react to a change of ownership? A highly concentrated customer or supplier base can create risk, not only if they fail but also if they might refuse to deal with a potential acquirer for competitive or other more emotional reasons. If it is possible to spread the base it is worth considering, and probably does not require professional advice.

Numbers

Do you budget and forecast for the business? If so, how successful have you been at achieving your forecasts? If not, why not? How do you plan for the resources required to achieve your targets? Returning to the theme of acquirers buying the future profits of the business, they can be best helped to assess them by reviewing your budgets and forecasts and gaining confidence from your ability to achieve expected results.

Also important is to be able to show a rising trend of profits and profitability. This should demonstrated over several years if possible so is not something that can be done overnight. Where there are blips they need to be explained honestly and consistently to be credible.

There may be one or two expenses or assets that are likely to be unattractive to a purchaser. Rather than have an embarrassing discussion during sale negotiations it may make sense to remove anything that has dubious business benefit – the company flat, overpaid relatives with little real value to the business, the nanny, gardener or handyman who never come to the office but can be found at the managing director's home, the sponsorship of the local cycling club because it is a personal passion from which the business gets nothing.

Costs such as these indicate that personal and business expenses tend to get mixed together, leading to a suspicion that there could be more and that the tax man might be interested at some future date when it could be the acquirer's responsibility.

It is also sound financial sense – the business should sell for a multiple of profits, if those profits are deflated by extraneous costs the reduction in the sale price will be several times the unjustifiable costs charged.

Due diligence

Due diligence is the process the potential acquirer goes through, usually with a raft of accountants, lawyers and the occasional industry specialist advising.

It is normally an extremely extensive check of all aspects of the business, can be time consuming and stressful and happens while you still have a business to run. Advance preparation is essential as it will reduce the workload, give confidence to the acquirer, reduce professional fees and make attempts to reduce the initial offer price less likely to succeed.

The acquirer needs to know whether what they have been shown is supported by fact, whether any cracks have been papered over and whether the hopes and expectations for the future have a chance of being met. While appearing to be similar to an audit it is, in fact, far more comprehensive and onerous.

The starting point for due diligence is a data room. The data room is a collection of everything that is relevant to the past, present and future running of the company. It will normally include at least:

- Share capital and statutory books
- Property deeds and leases, fire certificates, environmental reports
- IP registrations
- Product specifications
- Fixed asset registers
- Insurances – property, employer's liability, product liability, vehicles, business continuity etc
- Customer and supplier contracts
- Debtors and creditors ledgers
- Employee contracts and details
- Statutory and management accounts, probably for the last three years, budgets and forecasts
- Audit letters and recommendations
- Detailed accounting policies
- Super annuation, PAYG, GST and income tax, company tax returns and any compliance visits
- Bank accounts, loans, mortgages, foreign currency or interest rate exposure
- Commitments and contingent liabilities

Depending on the nature of the business there could be much more.

Do not underestimate the pressure that will be placed on you and the senior team, especially finance, during a sale.

It takes a thorough understanding of the business to know what belongs in a data room and possibly many man-weeks of scanning documents or copying files to set one up. It should therefore be part of the exit planning process to create, over a period of time, a repository for all these documents (in soft copy as the data room will ultimately be a virtual, online room).

In addition to being prepared for the due diligence process the act of putting a data room together will identify what records do not exist or where copies are missing. It also highlights areas where attention is needed – perhaps a lease needs to be reviewed or IP registered.

The actual sale process can be disruptive for staff and anything out the ordinary can create concern and rumours. A low profile gathering of data will become accepted practice whereas a flurry of activity looking for missing paperwork is likely to disturb the office workforce in particular.

Finally, do not underestimate the pressure that will be placed on you and the senior team, especially finance, during a sale. Anyone who has been through the process will tell you that they never expected it to be so onerous.

There is a real danger that by concentrating on the sale process takes effort away from continuing to run the business and it might be advisable to bring assistance to project manage the transaction internally to minimise the impact on the senior team.

Not all offers for businesses go all the way to completion and the worst scenario is for a distracted team to have let the business slip and suffer the emotional backlash of a failed sale having got used to a probable change in ownership and management.

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How a part-time CFO can help maximise value when you sell your business

The CFO Centre will provide you with a highly experienced senior CFO with ‘big business experience’ for a fraction of the cost of a full-time CFO. This means you will have:

- One of Singapore’s leading CFOs, working with you on a part-time basis
- A local support team of the highest calibre CFOs
- A national and international collaborative team of the top CFOs sharing best practice (the power of hundreds)
- Access to our national and international network of clients and partners
- With all that support and expertise at your fingertips, you will achieve better results, faster. It means you’ll have more confidence and clarity when it comes to decision-making. After all, you’ll have access to expert help and advice whenever you need it.

In particular, your part-time CFO will help you to ensure that your business has planned and prepared for an exit and that the sale process is managed in an efficient way to minimise challenges on price and prevent advisors’ fees from absorbing too much of the sale price. He or she will, for example:

- Help you to implement your strategy for growth and exit
- Identify where value can be maximised and eliminate unprofitable or low profit activities
- Ensure that shareholders’ interests are protected through a shareholders’ agreement
- Explain what incentive arrangements are available for key management and introduce them. These could include bonus plans aligned to the business objectives or option plans
- Ensure that property is held in the most appropriate manner for the business and any potential acquirer, freehold or leasehold, length of tenancy
- Review pension arrangements to identify any funding or future liability issues
- Protect intellectual property and ensure that R & D tax credit claims are made to help fund new intellectual property
- Review contracts and trading terms to ensure they are in place, up to date and enforced
- Identify risks to the business from suppliers and customers on whom the business may have become reliant and plan to spread the risk
- Improve the accuracy and timeliness of management information
- Introduce systems and controls to increase confidence in the integrity of the accounting information

- Improve and/or introduce forecasting processes and procedures so that budgets and forecasts can be used as dynamic planning tools
- Identify means of improving margins and reducing overheads to improve profitability
- Ensure compliance with PAYG, Superannuation, GST, Income Tax and Company Tax legislation while seeking ways to reduce the overall tax burden to you and your business
- Introduce you to corporate finance, legal and other advisers to help with all aspects of the exit preparation and process
- Project manage the exit process internally so that it minimises the disruption to other staff and their continuing responsibilities
- Create confidence in the acquirer and their advisers so that they have limited opportunity to attempt to negotiate the price down or increase warranties from you
- Help you achieve the freedom you want after the efforts that you have invested in growing business

Conclusion

A successful exit can be very rewarding, planning it is critical to maximising that reward. By planning ahead you will be able to sell faster, for more and ensure that you can plan your tax position to reduce the tax cost to shareholders so they keep a greater proportion of the sale price.

By demonstrating that you and your team have reliable information that allows you to report and forecast accurately you will be able to instil confidence in an acquirer and their advisors, minimising possible price reductions.

A part-time CFO from the CFO Centre will work with you to make your plans a reality by shouldering some of the burden giving you the opportunities to grow your business further in the knowledge that you will be able to market your business, or take advantage of an offer to acquire it, from a position of strength.

Book your free one-to-one call with one of our part-time CFOs now.

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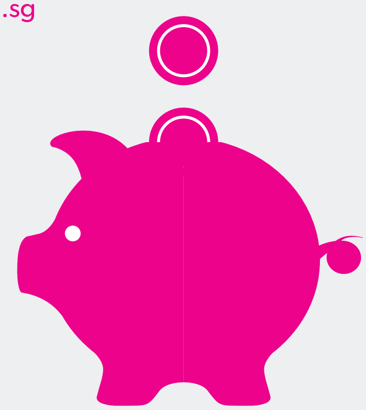

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