TAYLOR WALTON SOLICITORS

Selling your business: Due Diligence, Valuation, and Buyer Negotiation

[Nick Coffer]
Hello and welcome to this episode of TW Law Talk by Taylor Walton Solicitors, the podcast series which gets to the heart of legal issues which matter to you and your business. I'm Nick Coffer and today it's all about selling your business. What are the issues you should be thinking about now as you look ahead to all being, well, the most beneficial and, dare we hope, stress-free process for you and your business.

Joining me here in Taylor Walton's offices in St Albans is Simon Hughes, partner and head of corporate at Taylor Walton. Simon hello.

[Simon Hughes]
Hello.

[Nick Coffer]
And before we introduce our guest on today's episode, perhaps you can just briefly outline what you do within the business.

[Simon Hughes]
So, I advise business owners in connection with all aspects of their business in relation to what we're talking about today, particularly advising them in connection with preparing their businesses for sale but we also advise on the buy side.

[Nick Coffer]
And joining us from his office in Maidenhead is Clive Drysdale. Clive is a chartered accountant who's worked in senior executive board positions in both publicly quoted and private equity-backed businesses for over 20 years. He's completed over 50 M&A transactions both on the buy and sell side.

It's impressive, isn't it Simon, as I'm reading it. Subsequently for the last seven years he's been advising boards in a personal capacity on a variety of issues. Clive, welcome to the podcast.

[Clive Drysdale]
Thank you.

[Nick Coffer]
We'll focus today on three key areas, restructuring, problem-solving and estimation of sales price. Now Simon, if the lengthy notes that you provided me with are anything to go by, this is a complex and very involved subject.

In fact, one which we could probably do two, three or four episodes on. Let's start with the first of these three key areas, restructuring.

[Simon Hughes]
Well I think the very first question we look at when advising clients is what is it you're selling? And sometimes people who've been running companies for many years, they have several businesses all wrapped up in the same company. So, the question is, are you selling them all?

Do we need to strip things out? Do we need to add things back in?

[Nick Coffer]
How does that look Clive, in terms of what needs extracting, what needs to be put back in?

[Clive Drysdale]
It's really a matter of just going through and understanding what the actual business is and what is the core element you're trying to sell. And if there are elements in there that you don't want to sell, taking advice early as to how best to remove those. And also if there are assets that need to be moved into the business, again taking advice early on how to achieve that in the best possible way.

[Nick Coffer]
And of course there are different kinds of assets, aren't there Simon? You've got intellectual property, which is perhaps quite hard to tangibly evaluate. And then you've got machinery and actual real assets as well.

[Simon Hughes]
Yeah, that's right. And I think if you've been running a business for 20, 25 years, often these assets have migrated into different companies in the same group. So, we have to collect them all together to start with.

And I mean, a classic example is land. Very often there's land involved in business, but it's actually an excellent asset to strip out. So, you sell it out and you lease it back to the business.

And it provides a good pension income post sale. You've got to agree the valuation for the land and it should typically come out at market value and then lease back in at a market rate.

[Nick Coffer]
See Clive, this is where already I, as the lay person in this discussion, am struggling because I imagine a business has a value. It does something and it is worth something to someone else. And you're going to sell that business at that price to that other person.

Everything you've said in the first couple of minutes, both yourself and Simon, suggests that it is beyond multilayered. And there are a number of elements that come into play that perhaps are really quite complex.

[Clive Drysdale]
I think it depends whether it is a sort of corporate business that's part of a larger group where it will tend to be much more focused. But if you've got a family-owned business that

has been around for some time, inevitably they tend to branch out and do other things. And that may well be in the existing company, it may be in a new company.

I'm working on a job at the moment where it's a family-owned business and there are assets that need to be removed from the company. And then as Simon says, lease back because it's property and then there's other assets which need to be brought in which are sort of, you know, more fixed assets, plant and machinery type thing. But it's just a matter of going through and correctly identifying all of those early on.

If you don't do it early on, then it can lead to difficulties later in the process when everybody's trying to rush around and get the job done.

[Nick Coffer]
Simon, let's look at the question of owner managed businesses, a very particular part of this equation.

[Simon Hughes]
Yes, well, they are. I think one of the important issues to consider early on is what's the management structure going to look like after completion? If you've been an owner managed business and you've been active in the day-to-day management of the business, what's going to happen once you've sold it?

And it's an important question because most owner managers when they sell, they want to take the money, put their feet up. But if you've been very active in the business all the way up to completion, it's quite possible that the buyer will say, yes, we'd like you to stay on for a period after completion, maybe one, two years to ensure the handover. And the impact of that is that they may decide they don't want to pay you 100% of the value of the business on day one.

They want you to prove that the business is going to generate the revenues they're expecting over a one or two-year period after completion.

[Nick Coffer]
I guess what this comes down to as well is you have to ask yourself as an owner manager whether you want to be in that business post-sale or not, whether in effect you're making yourself redundant by selling the business or whether you will continue to be actively involved.

[Simon Hughes]
That's exactly it. And I think the sooner you make that decision, the better. One route if you want to leave the business at completion is to be looking around sometime ahead of completion, maybe 12 months, maybe 24, for a management team that can replace you but continue after completion.

[Nick Coffer]
And Clive, how can we incentivise that management team that will be in place after completion?

[Clive Drysdale]

I think there's one thing just to add to what Simon says before we move on to that. And what you have to remember is when somebody is buying a business, they're buying the customers and the cash flows, but they're also importantly buying the management to actually deliver that.

[Nick Coffer]
Yes.

[Clive Drysdale]
And that's why it's very, very important that you have the right management team in place. In terms of incentivisation, you can incentivise people pre-acquisition and pre-disposal and post-acquisition in a number of ways. It could be just cash.

If you do a good job, you'll get a bonus. If I sell the business and we sell it for X amount of money, you'll get a bonus.

[Nick Coffer]
Yeah.

[Clive Drysdale]
It could be in the form of shares, which would be an option scheme, and there are a number of those around, EMI options, growth options, for example. But inevitably, when the business is sold, those options will mature, and the shares will then be sold as part of the transaction. What that does is give the management team generally a lump of cash, which may change their views as to what they want to do in the future, whether they want to go and put their feet up on the beach as well.

[Nick Coffer]
I guess what's coming through here as well, Simon, is that it is absolutely key to not view the sale as the end point, but in fact, the start of the new era. As such, it's really important to have a long-term business plan in place, a proper integrated cash flow forecast as well, or else you're going to be stopping at the point at which you start.

[Simon Hughes]
Well, you've got to tell the story for the future, not just about the past. The buyer is only going to be interested in taking on the business if they think it's going to be generating cash flows into the future. I think in addition to that; you've got to work out what your USP is and plan for it.

It may require you to go and acquire additional assets in order to be able to tell a growth story going forward. Certainly, the buyer is going to want to see some kind of robust plan over a number of years and it needs to believe that the cash flow forecast is real.

[Nick Coffer]
What is clear is that potential buyers are going to request all manner of information about all manner of aspects within the business and we'll talk about due diligence in a moment. But Clive, I just want to ask you, perhaps almost as an aside, I've been in business myself, I've been involved in businesses and it can be quite an emotive and emotional thing, especially if it's a business that someone has grown from scratch and has grown into a

saleable asset. When you're dealing with mergers and acquisitions, when you're dealing with sales, how do you manage that line between pragmatism and reality and someone's, well let's say emotional attachment?

I guess what I'm trying to say is you must come across cases where that emotional attachment clouds the judgment on the true value of the asset that you're dealing with.

[Clive Drysdale]
I think you have to be very clear with the owners that one, they do actually want to sell the business and to actually take them through the process of how that's achieved. And if they are very, very emotionally attached and find it very hard, then it may be that you rely on the next layer down, particularly the people who are going to stay, you actually get them to sell the business rather than the actual owner. So it comes back to Simon's point from earlier where the owner makes himself redundant from the business and you've got a management team that take it forward and those are the people that the buyers will be more interested in.

[Nick Coffer]
It feels like there has to be an element of dispassion that comes in, in order for the process to work. Simon, the last thing that a seller wants is for a buyer to discover problems further down the line and perhaps problems that you weren't even aware of. Talk me through this process of due diligence or vendor due diligence.

[Simon Hughes]
Yeah, that's exactly right. The worst outcome is that you start down the road of a sales process and then you hit a rock in the middle of the road, something you didn't know about the business that's a problem.

[Nick Coffer]
Have you seen instances where you're 70, 80% down the line, you've put in a huge amount of work, invested a huge amount of time and resources, and that curveball comes in and the whole project gets derailed?

[Simon Hughes]
Absolutely. It's a disaster if that happens because people have a tendency to overreact and say, well, what other problems are in the business that I also haven't discovered? So I have seen the sales price drop by as much as 10% in the last few days of negotiation, simply because something wasn't disclosed at an early enough point in time when we could have put it right before the process started.

[Nick Coffer]
Isn't that normal, though, when you're buying a house, for example, people are looking to find ways to chip you down. Is that part of the process that you have to confront as a lawyer involved?

[Simon Hughes]
It is normal, but you really want to do everything you can to avoid it. So, we encourage sellers to carry out a due diligence process across their business because very often you can

solve these things and even if you can't solve them, you can manage the story. And if you're proactive about disclosing issues, then you generate trust with the buyer.

Say, well, OK, there's a problem, but all businesses have problems and they've been upfront and open about it and explained it.

[Nick Coffer]
So specifically, and obviously someone listening to this might be in exactly this position that they're mulling over whether to sell their business. And from what you're saying, it appears to me that the best thing they can do is to ready themselves and their business for that process. Talk me through the specific things, the actual things they can do to mitigate the risk of it being derailed further down the line.

[Simon Hughes]
Well, an obvious one is employment. All businesses require employees. Some of those employees are full-time, some are temporary and part-time.

The regulatory environment is so complex that you need to identify which categories each of these individuals falls into because different regulatory arrangements apply to them. So I would invite one of my specialist colleagues in the employment group to take a sample of the terms and conditions applicable to different individuals who work in the business and ensure that those are compliant with current legislation.

[Nick Coffer]
So, you would do that level of deep dive?

[Simon Hughes]
Absolutely. And if they're not, we go through the process of changing them. And that's something that can easily be done.

[Nick Coffer]
What about property?

[Simon Hughes]
Property is an obvious one. Most businesses have to use property to carry on and the property is either owned by the business or leased by the business.

And very often that can be on an informal arrangement because if you've extracted the property and the sellers own it, they may be allowing the business to use it on a rather informal basis. And what we need to do is put that on a real basis by putting in place a properly drafted lease that is probably a little bit favourable to the seller.

[Nick Coffer]
So, there's a fair amount of window dressing that is involved before even taking it to market?

[Simon Hughes]
Yes. Whether it's window dressing, I think it's formalising arrangements which may have existed in an informal way for many, many years.

[Nick Coffer]
Clive, I know you're a Liverpool fan, I'm an Arsenal fan, I don't have a huge amount of personal experience in selling large businesses, but I do remember that for many years selling Arsenal proved to be problematical due to minority shareholders. Is this an issue that you confront regularly in your work?

[Clive Drysdale]
It does happen and the important thing is that the main shareholder, if he wants to sell, he's actually got a mechanism for achieving that sale process. And so, if you have minority shareholders, occasionally you might find that they don't want to sell for whatever reason. And so, the way that the main shareholder can protect themselves is to have a shareholder's agreement which actually covers off what happens in the event of a sale and it's usually what's called drag-along.

So, the main shareholder can drag along the minority shareholders into the sale and so a shareholder agreement gets incorporated into the articles association. And again, that can all be done upfront, so it just doesn't become an issue.

[Nick Coffer]
Simon, if there's no scope or no agreement to create that drag-along provision, at that point is any future sale dead in the water before it started?

[Simon Hughes]
Well, it's a very early checklist item. You don't want to get anywhere near a sales process if you're not sure that everyone's going to be happy to participate in the sale.

[Nick Coffer]
And of course, this doesn't need to be just huge corporate entities with corporate shareholders. This can be a family structure for example where a business has been perhaps inherited, where you've got four siblings, a couple of cousins and an uncle and by definition they may all have very very different agendas.

[Simon Hughes]
That's exactly where the problem is most likely to occur. Family. In bigger corporate groups the subsidiaries are normally 100% owned but in families there may be a huge variety of different objectives, and you will have wanted to get in place something like a shareholder's agreement or provisions in the articles which can ensure that minority shareholders can be forced into the sale.

[Nick Coffer]
I am a family mediator by trade as well. I just have this image in my head of part of your job being about banging heads together and actually getting a family group in a room together and just really trying to find some point of agreement among what could be very very disparate views.

[Simon Hughes]
Yes, I think we get less involved in that process. We do obviously point out that enough of the sellers need to be on board at an early stage to ensure the sale process is viable and very often we have to leave the sellers to argue that one between themselves.

[Nick Coffer]
The next one may seem very obvious, and this is where I show my love of Dragon's Den. So, it's taken so long to bring Dragon's Den into this but often on Dragon's Den you'll see highly successful businesses that come in front of the dragons and within seconds the dragons say, well hold on a minute, you haven't got a contract. This is not a business.

There's no value here. Or for example, you're just one of many importers and there's other people who've got the same business. Yes, your business turns over money but actually it has no value.

This may seem obvious but am I right in saying that those contracts, those contracts with key customers and suppliers, they have to be very watertight in order for the business to have proper value?

[Simon Hughes]
Well, I think it varies from industry to industry and there's custom and practice where people will just deal with each other on relatively informal, unwritten terms and the main thing is you're supplying a product and you're being paid for that product. But in a sale process, the buyers typically are wanting to see and understand exactly what the terms and conditions on which you're trading are. And if you don't have in place standard terms and conditions of sale, you'll probably be required to summarise them as part of the sale process.

So why not go through the process of identifying whether or not you've got standard terms of purchase, standard terms of sale and we can help put those in place.

[Nick Coffer]
And this is the theme coming through this whole episode is the importance of pre-preparing to avoid all manner of pitfalls along the process of a sale. There appears to be a huge amount of work that is going to involve people like yourself, people like Clive, actually getting the processes in place before you even think of going to market. And Clive, for me, one of the things I know about the business world is it becomes ever more regulated, obviously depending on the field that you're in, but I'm guessing that's going to be a really important part of the process as well to ensure that you are regulatorily compliant.

Have I got that phrase right there Simon? I'm not sure that exists, but that you are compliant from a regulatory standpoint. That's going to be important isn't it Clive?

[Clive Drysdale]
Absolutely. You're trying to buy a business and it's taking an activity and you're not compliant with the law to actually undertake that activity. Your business is worth significantly less if anything at that point in time.

And that's why it's important that all the necessary licences and permits are in place. And again, that's where the lawyers can help you go through that to make sure that you do indeed have all of those in place.

[Nick Coffer]

Simon and Clive, I feel like it's time to reach the crux of this because my guess is that many people listening to this want to hear what is a value? How do we value our business? How do we know what we're going to be able to ask when we go to market?

And I appreciate Simon that your answer might be how long is a piece of string to this key question. But let's look together at that process. The process of working out how much you can get for selling your business.

Where does that process start with you and Clive?

[Simon Hughes]
I'll kick that off and then I may pass that over to Clive. Just with selling a house, there are agents who can help you sell your business. And you can go and discuss your plans about selling with those agents ahead of deciding whether you actually want to go ahead with a sale.

Those advisors can give you some ideas about what your business might be worth.

[Nick Coffer]
Do we trust having a middleman in this process? Are we not better off in effect bringing two parties together directly?

[Simon Hughes]
You don't always need one. And sometimes sellers have identified their own buyers and they're confident enough to have their own conversations and reach a provisional agreement. But very often there are a number of potential buyers in the market, and you need the guidance of an intermediary to help you through that process.

I think one point to note is not to commit to any intermediary too early in the process. Because like estate agents selling a house, if you sign up a document you could get committed to that agent for a period of say two years even though you're not certain that they're the right person for you.

[Nick Coffer]
So don't sign anything formal until you've spoken to a few people in the market and ascertained well I guess which one your favourite is.

[Simon Hughes]
Exactly right.

[Nick Coffer]
What do they charge? Obviously using the estate agent example they'll try and get your business by saying we'll do it for three quarters of a percent instead of four. Ordinarily what would an agent be looking at in terms of fee structures and how long would those periods of exclusivity be?

[Simon Hughes]
They'll tend to charge on a commission basis, but it can be a combination of a commission and hourly rates. It can also include abort fees so if you fail to sell, they might say well you

know you'll have to recompense us for the time we've spent advising you. So, I have to say I've seen a whole variety of different approaches to how you charge on the sale.

[Nick Coffer]
The purpose of this series is not to repeatedly say go and see your lawyer, go and see Taylor Walton but this is one of those moments where it's vital isn't it before you sign away your rights to an agent is to get that legally checked.

[Simon Hughes]
Absolutely I think it's one of the most important pieces of advice is just don't sign anything too early.

[Nick Coffer]
Because of course the worst-case scenario is that you sign too early with the wrong person. You may have been at that absolute prime moment for selling your business. You make a wrong decision that business then can't move for a year or 18 months.

You could have the kind of you know recession that we had a couple years ago or major event or Covid or whatever it might be, and you've lost your moment.

[Simon Hughes]
Yes, you could have lost your moment and so it's critically important that you look around talk around and make an informed decision about who you're going to run with if indeed you're going to run with anyone.

[Nick Coffer]
I suspect that this next question is a Clive question. How will a sales price be calculated? Clive how does it work?

[Clive Drysdale]
Well it can be calculated in many many different ways but quite often it is a multiple of EBITDA, which is earnings before interest, taxes, depreciation and amortization, and typically it's the accountant's easy way of saying that converts into cash and that is then multiplied by a multiple which gives you what's called enterprise value. This is where the intermediaries can actually help you here, because what you want to get them to do is to give you information about what are the sort of prices that publicly equated companies are trading at at the moment, and also what transactions have historically taken place and what multiples were paid in those transactions. Because once you understand that it will help you decide whether the value that's coming out of it is going to be sufficient for you to actually achieve that exit and if you're going to be happy.

[Nick Coffer]
And of course, that process of assessing the EBITDA data can then identify possible buyers as well by definition?

[Clive Drysdale]
Yes, and I think the important thing here is also that you might own the business, you might think you know the market, but there's actually all sorts of different potential buyers. There's both financial and trade buyers, they may not be in this country, you may not have

heard of them, but an intermediary is likely to have got some better information because of what they do in the databases they have. They could bring somebody from The States where they tend to pay higher prices into the process and you could do much better.

[Nick Coffer]
That data as well it needs normalising, doesn't it? It can be both reduced and increased?

[Clive Drysdale]
You could have a business which reports an EBITDA of X but there are items that are constituent part of that, that may not be what you call market rate. So, for example sellers tend to historically have taken dividends out of the business rather than taking a salary or topped up their salary with dividends but the salary is not market rate - and so to get your normalised EBITDA that the buyer will be looking at, what am I going to get going forward? He would increase the salaries in that EBITDA calculation so reduce the EBITDA.

Again, if there's changes in management, what's the cost of that management? We need to normalise that. And then there's for example, if there are costs in there that won't be in there going forward. If the sellers have all got Rolls Royces being run through the business and they're not going to be there going forward, you'd actually remove that and increase the EBITDA. I've got one example recently where a business was being charged for renting assets from another business they were going to buy those assets. On exit, the value that is being charged was significantly inflated so therefore you would increase your EBITDA and so it's really just trying to find what is the real profitability of the business going forward.

[Nick Coffer]
And that multiple can it quite literally be from 2 to 20? Is there any standard line on it?

[Clive Drysdale]
The multiple varies depending on you know what sector, what business, what the future holds, and they do range from very small to very large numbers.

[Nick Coffer]
Simon I just want to finish on this, because obviously for you the nuts and bolts of what you do is helping businesses sell their business. It's very much your daily bread if you like but where the fun starts, I probably shouldn't use the phrase in the context of litigation, but where the fun starts is, dare I say where it goes wrong for anyone listening to this. If for example you've picked a wrong buyer, someone turns out to be a crook, you've gone too far down the line, you're getting into trouble, what is your role at that point and how can you remedy it?

[Simon Hughes]
Well, we're very clear about never going too far down the line. Everything we discussed today is all at the preparatory stage. Once you've done all the preparatory work, there's still the negotiation of the whole transaction. So that will take several months. If your business is attractive to different buyers, we can sometimes run an auction process where we keep a number of buyers interested for quite some period through the process and in that way if somebody isn't playing fair, we can exclude them from continuing in the process. So, we try to keep as many options open for as long as possible, but it's not always the case that you can do that. What is always the case is that before we get to the final moment of

commitment, we will have taken sellers through all of the pluses all of the minuses all of the risks of committing to the transaction and they can decide right up to the last minute that they don't want to go ahead with it.

[Nick Coffer]
My sense with this whole episode out of all of your colleagues I'm talking to here at Taylor Walton, is that your particular field requires a certain conservatism. You need people to do it properly, to prepare properly if they are looking to sell, to be realistic, to be pragmatic and then when I use the term conservative, I obviously mean it with a small c. But that element of don't do anything silly because if you do it will come back and bite you further down the line. It will reduce the value, potentially prejudice the whole sale, and everything you've said and that Clive has said from his standpoint is about, for me, being sensible, being conservative and not trying to game the system.

[Simon Hughes]
Oh absolutely and I think full disclosure is the key. If you tell us everything about your business, we can help you put that in the right format to have a successful sale. The last thing you want is to have been paid your proceeds of sale on completion, you've got on the plane, you're on the beach in the Caribbean, and the phone goes because the buyer's got a problem with what it's bought. We hopefully will have ironed all of that out before you get to the moment of completion.

[Nick Coffer]
If it doesn't, that is the very definition of a face palm moment and it must happen to you where you've gone so far down the line in the process and something comes up and your face hits your palm, and you're thinking why on earth was this not brought to my attention six months ago two years ago.

[Simon Hughes]
I've had one deal that completely fell over the night before we were due to sign. It was an undisclosed cartel and if the buyer had gone ahead with that, the potential risk for the buyer would have been many many times bigger than the size of the business it was buying. So that was a deal killer. Other last-minute problems tend to factor through to price. We hope through this process of vendor due diligence, early-stage restructuring, thinking about what the post-completion picture should look like, that we can avoid those last-minute nasties.

[Nick Coffer]
And of course I'm stating the obvious here, because I'm talking to lawyers and chartered accountants, but more than ever this is a field that requires proper advice and it's advice that you're paying for in order to not come unstuck. It seems very obvious to me sitting on the other side of the table to you.

Clive just a final thought from you - anyone thinking of going down this process obviously I've talked about due diligence, I've talked about being open, being honest, and being conservative. What would your final thoughts, your final advice be to someone thinking of approaching yourself, of approaching Simon, in this context

[Clive Drysdale]
Just repeating what Simon said is when we first meet potential sellers, we actually say to them you have to be completely open and honest with us. You need to tell us everything and you need to accept that we need to go through a period to actually do the due diligence before we go out to sell. People think that they know their business, they think there's nothing wrong with it, but invariably there are things that come out, and so it's so much better to do it upfront get it clean and then you won't have a problem with pricing and the business transaction falling over.

[Nick Coffer]
Maybe Simon the summary of all of this is it's the process of getting out what has been in your head for potentially decades, into a format that other people who aren't in the business can actually understand.

[Simon Hughes]
Yeah that's very often part of it and just to allow a buyer to get certainty as to what it's buying.

[Nick Coffer]
And for some people who've been involved in business perhaps for 30-40 years, getting that information out of their heads can be tricky I'm guessing. Simon and Clive thank you both for your time, fascinating topic. I'm guessing the best way to get in touch with both of you would be Simon, if any listeners would contact you directly perhaps go to the Taylor Walton website, taylorwalton.co.uk, your email address there is simon.hughes@taylorwalton.co.uk, and you will put them in touch with Clive as well as part of the process.

If you enjoyed today's episode, please do follow the series that way you'll be notified of all future episodes. This series covers a wide range or a wide gamut of legal issues and hopefully brings you insight, brings you some advice, brings you some reassurance, as well brings you some explanation and perhaps debunk some myths along the way.

Clive really appreciate your time. Thank you, Simon, you as well. Until the next time from me Nick Coffer and from Simon and Clive it's goodbye.

[Simon Hughes]
Thanks very much.

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