PART NINE
Structures for growth

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Partnerships and collaborations

9.1

*Partnerships and collaborations are becoming an increasingly popular way to grow. **Rebecca Gardner** at Goodman Derrick discusses how to make sure that they work best for your business*

Whether you've got an idea for a new business venture or you're a well-established sole practitioner looking to expand your business, a partnership or collaboration could be the perfect solution.

What structure you decide to adopt will depend largely on the nature of the business involved and who the relevant parties are but it also pays to think about other factors, such as:

- the level of involvement of each party in the management of the new business;
- the level of potential liability for the debts of the new business;
- the tax consequences of your choice of business structure; and
- the administrative and financial burden of running the business.

Below we look at a number of hypothetical scenarios and consider the most suitable partnership or collaborative structure to suit each one. Clearly, in practice the most appropriate structure will depend on the specific facts and circumstances surrounding the new venture, but we have endeavoured to cover the most common options.

Scenario 1

Mr A is a vet who has been operating as a sole practitioner for a number of years. Another vet, Ms B has recently moved to the area. A and B have decided to set up a practice together with Ms B investing new capital to fund a move to improved premises and the purchase of new equipment.

Preferred option: Partnership or Limited Liability Partnership

Partnerships are founded on the basis of the talents and expertise of individuals. The partners are responsible for generating income and managing the business and as a result are entitled to take home a proportion of the profit.

Here, we have two veterinary professionals. Both could continue to operate as sole practitioners, but each recognizes the benefits of working together. For A, setting up a partnership with B will allow him to move to new premises and purchase new equipment, while reducing his share of the overhead costs of running the surgery and allowing him to expand his current client base. For B, while also benefiting from the halved administrative and overhead costs, as a new resident in the area, she will benefit from A's established practice.

Traditionally, under partnership arrangements, each partner was potentially liable for all and any debts of the partnership. Liability was unlimited. The Limited Liability Partnerships Act 2000 introduced the possibility of forming a partnership where liability is limited to the level of investment of each member. This has proven to be a popular alternative as members still receive the tax benefit of being self-employed, but the risk of unlimited liability has been removed. While LLPs are subject to more cumbersome registration and accounting requirements, the benefits of limited liability status outweigh this burden.

Things to consider: unlimited partnerships

- The partnership does not exist as a separate legal entity. All property owned by the partnership must be owned by one or more of the partners on trust for the partnership.
- Each partner must make annual self-assessment tax returns to HMRC. The partnership must also prepare returns and keep a record of all business income and expenses.
- Partners provide the initial capital for the business from personal assets or borrowing. They are each entitled to a share of the annual profits of the partnership.
- Partners are jointly liable for losses of the partnership. In the event of insolvency, a creditor can pursue any of the partners for the full debt owed.

It is essential to have a formal Partnership Agreement as this will govern how the partnership will be run, what the role and responsibilities of each partner will be and, most importantly, what will happen if the partners fall out or wish to terminate the relationship.

Things to consider: LLPs

- An LLP is a distinct legal entity – it can hold property and assets in its own right. LLPs must be registered at Companies House.
- The liability of each member of an LLP is limited to the amount of money that they have invested. However, where an LLP is seeking to secure external finance and it does not have sufficient assets to provide adequate security, members are often asked to give personal guarantees which extend their personal liability.

- Any profit of an LLP is split among the members proportionately unless the LLP Agreement states otherwise.
- Each member is treated as self-employed and must make annual self-assessment tax returns to HMRC. The LLP must also prepare and file annual accounts (in a similar format to those for limited companies) at Companies House.

Again, it is essential to have an LLP Agreement drawn up at the outset to govern how the LLP will be run and how any profits will be divided. It is also important to set out in detail what will happen if a member decides to leave the LLP.

Scenario 2

Concrete Castles Limited is a property developer that has recently come across an area of land that they believe would be perfect for residential development. Dollar Investments Limited is a small investment company that is always looking for new opportunities.

Preferred option: Special Purpose Private Limited Company

Private limited companies are most commonly used for joint ventures where one or more of the parties involved already have an established business. It is often the case that each party is bringing a different area of expertise to the new venture.

In Scenario 2 we have two established companies: CC has the knowledge and experience to put the development scheme into practice while DI provides the funding. By setting up a special purpose limited company, both parties can play their separate roles while still receiving a share of the rewards. The administrative burden of running a company, which can act as a deterrent for individuals, should not have the same effect here as both parties are familiar with the requirements.

By using a private limited company, CC and DI are also able to protect their existing businesses. Should the new venture fail, neither shareholder will be liable for the debts of the failed business.

Things to consider: Special purpose private limited company

- A limited company is a separate legal entity. The company's finances exist entirely separately from those of the shareholders.
- Companies must be registered at Companies House. They must also have at least one director that is a real person (ie not a corporate entity).
- The director or directors are responsible for the day-to-day management of the business, not the shareholders.
- Working capital is provided by shareholder investments, loans taken out by the company (usually secured against its assets) and retained profits.

- Accounts must be prepared each year in accordance with the Companies Act 2006. The level of detail and whether there is a requirement for them to be audited will depend on the size and turnover of the company.
- Profits are usually distributed to shareholders in the form of dividends but the company can retain some of the profits as working capital.
- A company is liable to pay corporation tax on its profits and shareholders are liable to pay income tax on dividends.

Special purpose companies will require bespoke Articles of Association and a detailed Shareholders' Agreement. These documents will deal with issues such as the issue and transfer of shares, the rights and obligations of each shareholder and what will happen if one party decides that it no longer wishes to participate in the joint venture. Also, where a company is owned 50:50, deadlock provisions are advisable to avoid stalemate situations should the parties not be able to agree on a particular issue.

Scenario 3

Emma runs a small dry cleaning service. Recently her business has been struggling because a number of rival businesses have been set up in the local area. Fresh & Clean Limited is a national chain of dry cleaners that have been looking to expand their presence in the region.

Preferred option: Franchise Arrangement

Fresh & Clean have an established business with a good reputation and a well-known brand. By franchising their business model, F&C increases its reputation and profitability by opening more branches, without assuming any of the risk of setting up a new business.

As franchisee, Emma will be licensed to use F&C's intellectual property and their format and will benefit from F&C's goodwill and reputation. She will also have a stronger bargaining position with suppliers.

Things to consider: Franchise arrangement

- An excellent way to take advantage of an already successful business model.
- A franchisee can operate their franchise as a sole trader, a partnership or a limited company depending on the size and nature of the business involved.
- A franchisee must pay a percentage of its profits to the franchisor each year before any benefit goes to shareholders or partners.

It will always be necessary to have a Franchise Agreement. It will dictate exactly what rights are being licensed to the franchisee and will ensure that the integrity and reputation of the brand are protected. It will also set out what percentage of profits will be paid by the franchisee to the franchisor. Again, exit and termination provisions will be important and should be understood fully by both parties before a formal agreement is signed.

Partnerships and collaborations are becoming an increasingly popular way for businesses to grow and expand. During times of economic uncertainty it can be advantageous to join forces with a similar-minded business to ride out the difficult times and in times of recovery, new business ventures can flourish.

Whatever your situation, it is advisable to seek both legal and financial advice early in the process. Goodman Derrick LLP has the expertise to provide you with advice and guidance on all available business structures and in turn could help you to make the most out of your business. Please note, this chapter is for general information and interest only and should not be relied upon as giving specific legal advice.

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Acquisitions that work

9.2

Strategic acquisitions can be an unbeatable route to growth, says ***Dr Mike Sweeting*** *at Acquisitions International, but there are five main ways in which they can go wrong*

Every time acquisition is discussed around a boardroom table a few simple issues jump out and bite straight away. These issues all have something to do with a lack of clarity as to what an acquisition can really deliver. Here are the issues, followed by some remedies! I have encountered them from both buying and selling perspectives.

Issue 1

Today there are around 40,000 businesses for sale in the UK. In 12 months' time most will remain unbought. Meanwhile, during the same time period, 60 per cent of acquirers will not have found a business to buy! This points to the incredible lack of overlap between what people want to buy and what people have to sell. Unless you wish to buy a printer or a sub-contract engineer, you are unlikely to find for sale already a business that will deliver you any real growth at all.

Solution 1

Look at the firms that fit best, not the ones that are being touted to you. Of course, most will not be 'for sale'. That need be no hindrance. In our own work we habitually approach shareholders of companies just getting on with life being modestly successful. When the dust has settled, 82 per cent will have spoken to us. Those who sell have been paid on average 10 per cent less than the going rate on a trade sale. The received wisdom that approaching companies results in higher prices is a fallacy – if the approach has been done the right way.

Issue 2

Even synergistic purchases do not necessarily produce growth. A new client told me recently that their company was the offspring of a corporate reshuffle. Their £20 million turnover firm bought a £60 million turnover firm and managed to turn the whole into a £40 million turnover firm! Not the kind of growth we are all looking for. Sixty-three per cent of the companies interviewed by Harvard Business School in a major survey indicated that their deals did not deliver to the level they had planned. Nobody decided: 'Let's go out and buy a firm that looks good but is useless really!' At the time of purchase the team thought otherwise. The advisor may have had private reservations but, hey, they needed the deal in order to get paid.

Solution 2

Establish a true choice of both purchases and possible homes for your money. Look at other routes to growth and run a budget on them. If acquisition is more cost-effective than opening another office, then do it. If acquisition gives you a better return on investment than doubling manufacturing capacity, then do it. If acquisition is a more cost-effective and reliable route to new product or service development, then do it. The failed acquirer has typically looked at eight or less companies during the notional 12 months. They have usually only looked at companies 'for sale'. They have not thoroughly investigated their alternatives.

Use advisors that do not entirely depend on a deal being done for their remuneration. Use ones that have a vested interest in your repeat business.

Issue 3

Because most purchases are either of what is offered or out of administration, strategic issues are often not discussed by the board prior to purchase. Everything is seen through a tactical 'set of spectacles' – 'Wow, that's cheap'; 'I like their client list'; 'Jim would be a great asset on the technical side'. All of this may be accurate, but is just rationalizing what you want to do. Strategy is something you decide on before you commence, not during the process. D-Day was not planned half way through the Battle of Normandy. Both were planned a year beforehand.

Solution 3

Plan *before* you start! Look at both the up and down side of acquisition in principle. Has it worked for others in your sector, for your competitors, for your peers? Then look at acquisition in comparison to your other options for growth as mentioned above. Finally look at what you want a specific acquisition to deliver in specific for your business. Resolve not to progress talks with firms that are less than an 80 per cent match with what you identify as crucial.

Issue 4

The money!

There are always far more deals that could get done than do get done. The human factor is always important (see below), but I think it is fair to say that money is the single quickest way to bring out that factor.

Research in late 2006 showed private equity winning 74 per cent of bids in competitive situations against trade buyers. Not only did this reflect a willingness to pay around 10 per cent more, but also derived from the fact that the PE firm had typically raised its fund, while the trade buyer so often expected to borrow on the target and couldn't get everything done in time. The issue is even clearer when we look at MBOs and MBIs. These are normally teams of individuals who are putting themselves on the line – resulting in deals that tend to transact at about 10 per cent lower prices than trade sales.

I find it fascinating that those who were unlikely to gain from amalgamating functions and other related savings were prepared to pay more. This is because they think entirely strategically. It is potential they are seeking to unlock, as a route to value. The trade buyer, who has most to gain immediately, is usually slow to make decisions and poor on the money management side. The MBO/MBIs are treated by sellers as poor relations.

The recession knocked these verities about a bit, but things are now not far off the previous status quo – just with fewer outfits buying!

Solution 4

Always secure your line of finance before making a firm offer. It's fine to make an indicative offer prior to funds being secured, but there is still the risk of your offer being accepted! There is nothing more detrimental to your credibility than not being able to progress a deal because funds are held up.

Most trade buyers want to borrow on the target. Most lenders want to lend on the buyer! If your bank will not consider lending to you on your own assets, cash flow or profit, I would argue that you are in too marginal a situation to afford the right buy. Of course, there is always an exception to the rule. Why are you it?

If you are a MBI team, build credibility. Lenders lend on the proposal, the people and the purchase. Are all three equally credible, or does one let you down? The same principles apply for any form of leveraged deal.

Issue 5

The people!

I am afraid that we are now on ground where no statistic helps and no pattern can be relied upon. What can be said, is that if yours is a people business, there is no more risk in buying a people business than using normal recruitment practices. In fact, observationally, there is often less risk since you are buying a proven functioning team, not a ragbag of individuals. Cost wise, acquisition can usually also be well-justified in comparison to recruitment fees etc.

If you do not see yourself as being in a people business, then you are wrong! Even the most techie IT firm has a human face, which we neglect at our peril. For instance, if you are buying a division or subsidiary off a large group ask yourself why it has not been offered to its own management. Maybe it is already under offer from the very same people you expect to work well for you after the shareholders have exited. Maybe they have been turned down in your favour. How workable is the business after purchase in such circumstances?

Solution 5

Put as much time into checking out the people as you do into valuing the assets, analysing the cash flow or computing the tax. Remember, your target is also supplied by people, discussed by people and supplies people.

So there you go. I feel like an agony aunt now! By now you can spot that I regard strategic acquisitions as an excellent route to growth – with much evidence – and perceive tactical buys to be all very well, but unlikely to deliver what you really want. There are cheaper, less-risky ways to organic growth than bolt-on acquisitions. There is only one other route to substantial ‘step-change’ growth beside a strategic acquisition – marketing something new that everybody wants at a reasonable price!

Summary

- Good acquisitions perform as investments.
- Good acquisitions give a ‘step change’.
- Good acquisitions further strategic goals.
- Good acquisitions add value to your shares.
- Good acquisitions help you to diversify.
- Good acquisitions give you ‘critical mass’.

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He likes rock climbing, poetry, military history and shooting – some of the things he finds as stimulating as getting a deal done!

Licensing

9.3

In finding the best route to market, licensing can be a powerful tool. ***Tony Randel****, a consultant at Animus and an advisor to the Intellectual Property Office, explains how it works*

When you mention 'licensing' to most people in the UK they immediately think of pub opening hours or a vehicle tax disc. Not so in most other industrialized countries; they think of the commercial implications of the word. As the UK economy becomes based more and more on our creative and inventive skills, as opposed to our traditional strengths, it is vital that all UK businesses look for new, imaginative and innovative business tools that they can all use to grow, find new or faster routes to market and gain competitive advantage. Licensing is just such a tool.

Lots of businesses are conservative in their business model and apprehensive of doing anything outside their 'comfort zone'. 'We have always done it this way and we know it works' is a common cry; but might it not work better if they tried something innovative? Licensing, in itself, is not new but it can be a novel and alternative approach for many businesses to escape from their traditional comfort zone to gain competitive advantage. This is particularly so in a world where times to market are getting shorter and windows of opportunity for new product introduction are getting smaller.

So what do we mean by licensing? It is best described, in this context, as 'permission to do something that, without the licence, would be an infringement of intellectual property'. The expression 'intellectual property' should be construed broadly to encompass soft IP (know-how, trade secrets, unregistered designs, unregistered trade marks etc) as well as the harder actual IP Rights. Having defined what we mean by licensing let us consider for a moment some of the possible business benefits of licensing.

Revenue Generation: An owner of IP may commercialize that IP itself within its own industry sector. It may then obtain additional income from that same IP by licensing it to someone else to commercialize it in a different field.

Increasing Market Penetration: An owner of IP may license another business to manufacture and/or sell in territories that the owner cannot or does not want to cover.

Reducing Costs: A business may 'buy-in' IP that has been wholly or partially developed by another to reduce its research and development costs.

Saving Time: A business may get its products or services to market more quickly by acquiring a licence to use existing IP, rather than re-inventing the wheel, even if that IP has to be modified or further developed to more exactly suit the requirements of the business.

Accessing Expertise: By taking a licence, a business may tap into expertise that it does not have in-house. This is particularly relevant if a business needs very specialized knowledge that might only reside in an HEI or Research Institute or requires the IP for so short a time that employing someone with the knowledge is not a sensible option.

Obtaining Competitive Advantage: By acquiring a licence to use certain IP, a business may obtain an advantage over its competitors who have not been able to acquire that IP.

Collaboration: Businesses may want to work together to develop new products and services to their mutual benefit.

Redundant IP Assets: Many businesses have IP assets that they have developed over the years but are no longer of use to them. These assets can often be turned into a very useful income stream by licensing.

The possible benefits above may seem attractive, and indeed are attractive to many businesses. However, there are circumstances when licensing is not the most appropriate tool for a business. Every business must carefully examine, possibly with help from an experienced licensing professional, their own circumstances and then develop a licensing strategy.

If we assume that a business wants to at least examine the possibility of licensing in or out how do they find a suitable licensing partner? Remember here that a licence is a long-term agreement between partners that must be to their mutual benefit. It can be likened to a marriage – it is usually relatively inexpensive to get into but can be extremely expensive and stressful to get out of! By far the best way of finding a partner are by personal knowledge, by word of mouth or through a trusted intermediary. There are a number of more formal mechanisms and many 'technology brokers'. Some of these are extremely good, highly reputable and very successful in their matchmaking activities. Others, unfortunately, are less good and some have a fairly dubious reputation. Any business new to licensing should take advice from a trusted, or at least recommended, advisor who is governed by a Code of Professional Conduct, or similar. UK IPO has recently produced a guide entitled 'Choosing your IP Advisor' to assist businesses new to this activity.

Once a business has decided that they want to embrace licensing as part of their business strategy and they have identified possible partners they must give some consideration to the contents of any licence agreement. The terms of the licence are those under which the two businesses will cooperate and must be fair to both parties. There is no such thing as a 'standard' licence agreement or a template. Every case is different and must be treated on an individual basis. However, there are a number of common elements in most agreements; these are:

- What IP is being licensed? This needs spelling out in detail, including the hard and the soft IP; it may include certain drawings, bills of quantities, operating procedures – often as an Annex to the agreement if complex.
- Who may use the IP? A company, a partnership, an HEI, any of their subsidiaries or joint-ventures etc? Ensure that you detail this sufficiently and ensure that the other party is authorized to enter into such an agreement.

- The type of licence? Is the licence sole, exclusive or non-exclusive? What limitations are there concerning industry sector, geography, etc? Can the licence be sub-let, if so on what terms? Include the duration, with options on renewal and renewal options.
- Improvements. Who owns any developments or improvements?
- Infringement. Who is responsible for and who will pay for fighting apparent infringements or accusations of infringement?
- Quality and conformance. Who is responsible for ensuring that the items under licence meet the required quality standards and conform to any other national or international requirements.
- Charges and payments. Initial payments, royalties, penalties for non-performance, advances on royalties etc.
- Termination. Detail the various grounds upon which the licence can be terminated by either party.
- Various legal. Warranties by both parties, the law governing the agreement, is the agreement applicable to successors in title etc.

The list above can only give a very broad indication of what might be included and is certainly not exhaustive. A full and detailed list of matters to consider can be found in a number of publications; particularly the UK IPO booklet on licensing, and its very comprehensive checklist, which is specifically aimed at the SME without previous licensing experience.

Charges and payments are mentioned above and must feature high on the list of matters for consideration by both licensor and licensee. So how does one value intellectual property, or more specifically in this context 'agreeing a price for IP'? This subject is regarded by many as a 'black art'; as indeed it is. However, there are various mechanisms used by licensing professionals that at least turn it into a 'grey art'. The three most commonly used mechanisms are 'The Cost Method', 'The Market Value Method' and 'The Economic Benefit Method'. All three approach the issue from a different angle but each is constrained by the amount of information available or by possibly unreliable forecasts. A good and experienced licensing professional will attempt to use each method in any particular case in the hope that there is some commonality in the outcomes. Such calculations are then tempered by 'industry norms' and the very basic '25 per cent/5 per cent' rule. If both parties address this issue separately they will often come to very similar conclusions that will go some way to dispelling the often-unrealistic expectations of one or other party.

We have travelled down the route to entering into a licensing agreement by stages. First 'are there benefits for my business', then 'finding a partner', next 'what am I letting myself in for – the contents of the agreement' and finally 'what's it worth'. There is no set of rules under which licences are negotiated. The methodology below is intended purely as a guide. It has worked successfully many times, particularly between SMEs, but is not written in tablets of stone.

- **First meeting.** Principals only involved, more 'get to know you', 'can we do business together' than anything else. Probably held on neutral ground. If either party is not 100 per cent happy, walk away from any involvement.

- **First exchange of documents.** Disclosure of confidential information; possibly very first draft 'Heads of Agreement', usually prepared by licensor. Hopefully some heads agreed electronically. Second, more detailed draft tabled electronically.
- **Second meeting.** Again, only principals involved; often at the premises of the licensee; firming up the personal relationship; discussion over second draft, hopefully most heads agreed but there will almost certainly be certain matters that cannot be agreed or have to be referred to more senior decision makers. Further electronic exchanges, but if still no agreement:
- **Third meeting.** With experienced advisor(s) present to facilitate the negotiations over 'sticking points'. Heads of Agreement signed.
- **Finally.** Heads of Agreement turned into full licence agreement by lawyers for one or other party, usually the one that produced the initial heads; other party completes due diligence and agreement is signed.

Many UK businesses are frightened of licensing. They have heard anecdotal evidence of people being 'ripped-off' and they are unsure of how to go about it. They are therefore apprehensive of even exploring the issue. UK plc will only thrive into the 21st century if industry really accepts that it is operating in a global economy. To take advantage of that, rather than be left behind, businesses should think much more seriously than they have done in the past about licensing being a part of their strategy. If the business is diligent and uses the right advisors even the 'licensing virgin' should be able to make their way safely through the minefield to a happy, long-lasting and profitable marriage.

Contributed by Tony Randel on behalf of the UK Intellectual Property Office. Tony works for Animus, a small consultancy business in south west England, see: **www.animusconsulting.co.uk**. In previous existences, in manufacturing industry, he has been on both sides of successful licence agreements. He has been advising knowledge-based SMEs in the south west on intellectual property, product development and licensing for the last 20 years. He is a Fellow of the Institute of International Licensing Practitioners and represents that Institute on the UKIPO working party, formed as a result of the Gowers report, concerned with the licensing, and other methods of exploitation, of intellectual property by SMEs. He has co-authored some of the IPO guides on the subject.

The series of guides so far produced by this working party, including the licensing guide and checklist, can be found on the IPO website at: **www.ipo.gov.uk/whyuse/business/business-support.htm** as part of the IP Health Check series.

Preparing a business for sale

9.4

__Peter Gray__ at Cavendish discusses techniques for improving your worth to potential buyers

Maximizing the valuation achieved on a company sale takes time and careful preparation. Work can take place over a few months or even years before a sale to enhance the attractiveness and value of a business to potential purchasers. This is achieved by measures such as:

- identifying potential purchasers early and positioning the company to attract them;
- raising the public profile of the company;
- maximizing recurring profits by reducing or stopping non-recurring costs;
- improving margins through cost-saving measures;
- eliminating excess working capital from the balance sheet.

A review of the business to determine appropriate pre-sale preparation should cover the following areas.

Financial matters

Pricing review

Even where a company enjoys a degree of pricing power, it may choose not to fully exploit that power. Generally, the pricing policy of a company is designed to maximize long-term rather than short-term profits. This may involve keeping prices sufficiently low to deter potential market entrants. However, in the context of sale, consideration should be given to enhancing margins by increasing prices in the lead-up to the sale to improve the bottom line.

Review of costs

A review should be undertaken to identify and eliminate all proprietorial costs that would not be incurred by an incoming purchaser. Proprietorial costs may include relatives on the payroll, excessive travel and entertainment costs, and remuneration that exceeds accepted market norms. Although a purchaser might be persuaded that these costs should be added back to determine the company's underlying profit, the argument is always stronger if the business can be run for a period with these costs removed.

Every other element of the company's cost base should be also scrutinized. If your business will attract a multiple of say eight times earnings, every £1 of cost savings achieves an eight-fold return in the form of a higher purchase price.

It is not just the quantum of costs that should be reviewed but also their impact. For example, seek to ensure that expenditure on advertising, business development and R&D is designed to produce shorter-term results to help achieve a higher valuation, rather than long-term results that may not.

Review of assets

When a business has assets that may not be required or fully valued by a purchaser (such as surplus property or investments) removal before a sale commences is recommended.

In addition, in the lead-up to a sale, working capital should be reduced to the minimum level required to run the business. Policies concerning stock-holding levels, debtors and creditors should therefore be reviewed at an early stage to ensure that there is no 'fat' in working capital. If the company is sold with excess inventory levels or, owing to poor credit collection, excess levels of debtors, the vendor is, in effect, gifting the excess working capital to the purchaser. Any surplus working capital should be eliminated well in advance of a sale and the resultant cash proceeds either stripped out of the company or, preferably, added to the purchase price.

Any hidden or undervalued assets of the business should also be identified. If the value of property assets is understated in the company's balance sheet relative to their market value, they should be re-valued independently prior to sale.

If the company owns the property or properties from which the business is conducted, a higher overall valuation can be achieved by either selling the property to an institutional property investor prior to the sale and leasing it back or acquiring the property from the company at the time of the sale and leasing it back to the new owner.

Tax review

All PAYE, VAT and corporate tax matters should be up-to-date and tax computations agreed with the Inland Revenue. Any tax losses available to be carried forward, or corporation tax benefits from an Enterprise Management Incentive Scheme, should be identified so that value can be obtained for them from a purchaser.

Pension schemes

Final salary schemes can be very problematic in the context of a sale owing to the associated valuation issues. Subject to any regulatory constraints and the rules governing the schemes, a final salary scheme should be closed to new members immediately and, if possible, commuted into a defined contribution or personal pension scheme.

Accounting policies

With a sale in mind, a review should be undertaken of the following accounting policies to maximize stated earnings and balance sheet values:

- Recognition of profit, particularly for contract-related businesses.
- Depreciation policies, both for tangible and intangible assets – the policies may be overly aggressive with a resultant depression of profits and asset values.
- Provisions – making excessive provisions against stock or debtors is one of the most commonly used techniques to reduce tax. In the lead-up to a sale, excess provisions should be released to boost profits and asset values, preferably over more than one accounting period.
- Valuations of properties and intangible assets.
- Research and development – this may play a large part in the purchaser's interest in the business. Small companies are frequently bought for their innovative skills and product development capabilities. Where all research and development has been written off in the past through the profit and loss account rather than capitalized, this should be identified and highlighted.

As with excessive proprietorial drawings and one-off items, it is possible to adjust stated profits in the information memorandum to show the impact of using more conventional accounting policies. However, purchasers are always suspicious of 'add backs' and in the context of a sale it is preferable to show the highest profit figure possible in the company's audited accounts. Even if this involves paying some additional corporation tax, it should be more than compensated by the increase in the purchase price that can be achieved.

It is important to avoid the temptation to adopt overly aggressive policies that may lead a purchaser to adjust the company's profits downwards in due diligence.

Accounting systems

It is essential to have high-quality monthly management accounts and have in place good management information systems that track Key Performance Indicators (KPIs) and produce timely reports on key variables. During a sale, it is vital to have up-to-date, high-quality information on the current trading performance of your company and the purchaser will be looking to the vendor to warrant a recent set of management accounts.

It is equally important to produce high-quality budgets. At a minimum, a purchaser will be looking for profit projections for both the current and the following financial year. In the case of financial buyers, a three-year financial plan with detailed supporting assumptions will be required. If the company has not had a history of producing detailed budgets (and hopefully beating them), any projections produced specifically for a sale may lack credibility.

Operational matters

Management review

The quality of the management team will generally be of paramount importance to a purchaser, especially where the vendor is proposing to leave the business at the time of, or shortly after, a sale. It is important to be able to demonstrate to the purchaser that there is competent second-tier management available to assume executive control of the business following a sale. This will involve the vendor devolving management control in the lead-up to a sale. Where second-line management is taking executive decisions, their decisions should be documented. For evidentiary purposes, it may help to recognize their input formally by:

- minuting management meetings;
- issuing formal job descriptions;
- promoting senior management to the Board.

It might also be advisable for the vendor to take an extended holiday before the sale to show the purchaser that the business can operate effectively in their absence. It may be a warning sign for a purchaser if the vendor has rarely taken holidays as this may indicate that they make all the important decisions within the business and have no confidence in the management team. For the same reasons, it is a danger sign if the vendor is the only director.

Quality marks: non-execs and professional advisors

The appointment of an experienced non-executive director or chairman can assist a company in various ways. Apart from assisting in the strategic development of the company through his business acumen and contact base, it is likely that the non-exec will have been involved in several sale processes and can help guide the vendor through a potentially complex and stressful experience.

Moreover, if a highly regarded industry figure accepts the offer of a non-executive directorship, this gives the company significant credibility as a person of such standing will not accept an offer unless the non-exec believes the company is of high quality and has strong growth prospects.

It also helps if the company has high-quality auditors and professional advisors on board. Purchasers will regard this as a mark of quality. In the case of auditors, purchasers will accord significantly more credibility to accounts that have been audited by a well-known firm of auditors.

Legal review

In the lead-up to a sale, the vendor should consider conducting a legal audit in conjunction with the company's legal advisors, which should, at a minimum, ensure the following:

- Trading contracts are examined to ensure that no change of control restrictions or provisions apply.
- Provisions in key contracts that allow the other party to terminate the contract on a sale are potential 'poison pills' for a purchaser as the contracts in question may have considerable value. To the extent possible these provisions should be resisted.
- Intellectual Property rights are properly registered. For high-tech companies, deficiencies in patent or other IP registrations can have a major negative valuation impact and sometimes deter purchasers altogether, especially where a third party has challenged the validity of an important element of the company's IP. Where overseas expansion forms a key part of the company's growth story, it adds to credibility significantly if the IP rights in the territories targeted for expansion have been registered.
- Shareholder agreements and the company's articles of association are examined to review provisions relating to a sale.
- Where possible, any outstanding litigation is cleared up. If it cannot be resolved, and is not covered by the company's existing insurance, litigation insurance might be considered to remove it as an issue on a sale.
- To the extent possible, the ownership structure of the company is simplified. This may involve buying-in minority or joint venture interests. Complex ownership structures can diminish the attractiveness of a business.
- All leases, title deeds, share certificates and key contracts are located and reviewed.
- Any issues relating to the ownership of the company's assets including IP rights are resolved.

Positioning

Well before a sale exercise is undertaken, potential purchasers or categories of purchaser most likely to be interested in acquiring the business should be identified and the business positioned as an attractive acquisition target for those purchasers.

Corporate strategy

Before making any strategic decisions, you need to assess whether it would enhance or detract from value from a purchaser's perspective. This ranges from the obvious, such as not renewing a 20-year lease on the company's premises just prior to a sale, to more subtle positioning-type issues, such as whether diversifying the business into related activities will make the company more or less saleable.

Environmental audit

Potential environmental liabilities will be a major area of concern for any purchaser.

Depending on the nature of the business, it may be appropriate to commission a specialist environmental consultancy to conduct a desktop environmental audit or (in the case of premises with potentially significant environmental issues) a full environmental audit including ground-testing prior to the sale to enable any potential problems to be identified and remedied at an early stage.

Data room

Gathering information for a data room at an early stage can significantly truncate the subsequent sale exercise and is an essential component of the information disclosure process.

Vendor due diligence

Vendor due diligence involves instructing a reputable firm of accountants to prepare a due diligence report on the business in advance of a sale being undertaken. The report is then given to potential purchasers who have expressed serious interest in the company for use in finalizing their offers.

The purpose of vendor due diligence is to flush out financial, tax, operational and other issues relating to the business at the outset of the sale and in conjunction with the data room, to ensure that final bids are based on all 'price sensitive' information. If this objective is achieved, the chances of the deal collapsing or the purchase price being reduced once heads of agreement have been signed and a preferred bidder chosen, are significantly reduced.

In choosing an accountant, it is advisable to appoint a top-tier accounting firm and avoid the temptation to use the company's auditor. If this rule is ignored, a purchaser is more likely to use another firm of accountants to conduct final due diligence rather than adopt and update the vendor due diligence report after being confirmed as preferred bidder. Adoption of the report by the purchaser is a key objective of the vendor due diligence process, as introduction of another firm of accountants will have timing implications, leaving the business vulnerable to the new accountants taking a different view on certain financial issues or the validity of the financial projections.

Prepare for site visits

The impression that purchasers take away from site visits can have a significant impact on their appetite to acquire it. If they experience a desultory greeting at the reception desk, witness peeling paintwork and a premises in a general state of disrepair and form a negative view of employee morale from a walk around the office, their initial interest may quickly fade.

Purchasers will use site visits to determine whether the business represents a good cultural fit with their own as this is generally a prerequisite for a successful acquisition.

Conclusion

The more prepared a business is prior to the commencement of the sale process, the greater the ultimate valuation achieved will be. However, it is important not to prepare the business for sale in an over-zealous fashion or attempt to boost profits in artificial ways that will be exposed during due diligence.

Cavendish Corporate Finance LLP is a London-based corporate finance boutique and a leading independent specialist advisor to vendors of businesses. Founded in 1988, Cavendish has advised on some 400 company sales with an aggregate value in excess of £3 billion. Cavendish's clients include private companies, financial institutions and fully listed public companies with typical transactions falling broadly within the £10 million to £150 million 'mid-market' value range. Cavendish is unique in that it has only ever acted for vendors of businesses and as a result has built up an unrivalled specialist expertise in managing the company sale process. Cavendish is a member of M&A International Inc, the world's leading alliance of specialist mergers and acquisitions advisors and investment banking firms. Cavendish's expertise and success in selling businesses is acknowledged in our being named Corporate Finance Boutique of the Year at no less than four leading industry awards ceremonies in 2007 and 2008.

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