7 THINGS TO CONSIDER

WHEN BUYING OR SELLING A BUSINESS

Acquiring or selling a company is a major process and requires careful planning. As a seller, you can only sell your business once, so you need to do it right. As a buyer, you need to ensure you know what you're buying and that the price is right.

This Guide sets out some initial matters to consider when you are approaching a sale or purchase.

1. WILL THE BUSINESS BE SOLD AS A SHARE TRANSFER OR SALE OF ASSETS?

If the business is sold as a share transfer, the seller transfers their shares in the company to the buyer. If it is a sale of assets, the company shares are retained, and the buyer purchases the business (assets, stock, goodwill, etc.) from the company.

Share transfer

With a share transfer the seller is selling the whole legal entity that is the business - the complete package of assets and liabilities – and the buyer steps into their shoes. It is important to note that the transaction is between the seller as an individual and the buyer, not between the company and the buyer. So the buyer makes a payment to the seller's personal bank account. Once the shares are sold, the seller will no longer own any part of the business.

Sale of assets

In an asset sale it is the assets of the company that transfer to the buyer. The liabilities of the business are (usually but not always) retained in the company. The deal is between the buyer and the company, not with the seller personally, and the purchase money will be paid into the company's bank account. After the sale, the seller will still be the owner of the company, but it will be a company with little or nothing by way of assets. The company will still (usually) have the liabilities, such as outstanding VAT. The seller will quickly tend to use funds remaining in the company bank account to pay off the liabilities and then close the company.

Which to choose

Buyers generally prefer to purchase assets rather than shares, whereas sellers prefer to sell shares – it's a clean break and is more tax efficient. Which option to choose may depend on a number of factors:

- Does the seller want to continue with the trade name of the business?

- Is the business only one part of a larger business which will continue?

- Is the seller going to remain with the business as a consultant?

- Are the assets/liabilities of the business unusually complex?

2. IS YOUR BUSINESS 'SALE-READY'?

It is important for a business to be in good shape for a sale, to ensure the seller realises the best price possible. The sale is an opportunity to crystallise the value that the business owner has invested over the years, often over a generation. Early planning significantly increases the chance of a successful outcome.

It can take some time (even years) to get a business in the right shape to maximise exit value. Preparation puts a seller in a strong position to negotiate a favourable price, and helps ensure a smooth sales process. Sellers need to make it easy for buyers – a buyer made nervous by looking at the books will either try to lower the seller's intended sale price or walk away from the deal altogether.

Questions to consider:

- Is there a pipeline of orders and prospects? This will give the buyer confidence that the business has momentum. The seller should be clear about the sales potential and be able to provide evidence by creating a history of sales prospects and conversions. Are customers locked-in to formal contracts or secure letters of intent? Are the documents and contracts used reliable?

- What is the evidence showing business performance? The buyer will want to see at least two years of management accounts – these should be prepared in advance. The easier it is for the buyer to digest information about the business, the more confidence it will inspire, and the better the final deal is likely to be.

- Are the business records in good order and up to date? Current and historical financials will be looked at closely during the due diligence process. If it is possible to improve the position ahead of the sale (profit & loss, cash flow and budgets) this will enhance the eventual deal value.

- Are there any outstanding legal disputes, employee issues or IP considerations? Ideally, these will be resolved ahead of a sale. Are employment contracts sufficiently robust?

- Does the business legal structure need to be updated? It is more cost-effective to sell a streamlined group than one with many subsidiaries and legal complexities.

- Does any part of the business need to be hived off before a sale, or certain assets extracted?

- Are there any contractual or regulatory issues to be dealt with in advance? These might include the transfer of permits/licences, landlord permission to assign a lease, and change of control provisions in commercial contracts.

3. WHEN SHOULD YOU USE A CONFIDENTIALITY AGREEMENT?

The seller will want the buyer to sign a confidentiality agreement or non-disclosure agreement (NDA), to maintain confidentiality throughout the process. The fact that a business is on the market is often itself commercially sensitive: it could be damaging if customers or staff find out about a potential sale before it is agreed.

The sale process will also involve the seller providing information in relation to the business to the buyer and their advisers – see the section on due diligence below. A confidentiality agreement ensures that confidentiality around the whole process is maintained. It also restricts a party's use of the information, and has penalties for breaching the terms such as payment of damages.

A generic document is unlikely to be comprehensive enough or meet the specific requirements of the transaction. A tailored agreement should be prepared in each case.

4. WHAT IS DUE DILIGENCE?

Due diligence is the process by which the buyer carries out a thorough investigation into the business before committing to purchase. It includes enquiries about the financial status of the business, the customers, the employees and contractual relationships. The process will involve reviewing relevant documentation. Often these are placed in a virtual 'data room' to allow access with appropriate safeguards.

The buyer may need to take advice from their solicitor and accountant on due diligence, and they can put due diligence enquiries to the seller. This is often in the form of wide-ranging questionnaires following the agreement of Heads of Terms. The buyer needs to ensure they enquire about all relevant matters although the seller can often be frustrated at being faced with requests for information that take up valuable management time.

Warranties

Sale & purchase agreements will invariably contain warranties from the seller to the buyer. The purpose of a warranty is to provide a contractual statement to the buyer as to the asset they are buying. For example, warranties that the seller owns the shares of the company, or that all material contracts have been disclosed. If the warranty turns out to be untrue, the buyer then has a contractual claim for damages against the seller.

However the parties will usually agree that if something is referred to in a 'disclosure letter' – a document prepared by the seller – then this prevents a warranty claim being made in relation to it. Matters referred to in the disclosure letter should have come out as part of the due diligence process. Disclosures against relevant warranties should not therefore be a surprise.

Effect on purchase price

If the disclosure letter is a concern to the buyer, it will likely to lead to a negotiation of the purchase price. Once the due diligence process is completed, the financial terms of the deal can be adjusted to

deal with any issues identified. The contractual terms can also be adapted to address any ongoing risks to the buyer.

Due diligence is essential to ensure that the buyer and seller properly address all issues in negotiating a deal, and avoid any surprises after the deal has been done. Properly carried out due diligence enables the deal to complete more smoothly and reduces the scope for post-completion disputes.

5. DO ALL EMPLOYEES HAVE TO BE TRANSFERRED TO THE BUYER?

For most business purchases, whether Share Sales or Asset Purchases, TUPE will apply to transfer employees to the buyer. ('TUPE' is shorthand for the Transfer of Undertakings (Protection of Employment) Regulations.) This means that employees are not made redundant. They should be transferred on similar terms to their current employment and at the least under no worse terms.

6. WHAT'S THE PRICE?

There are many ways to value a business and put a sale price on it, but in any particular transaction the price will depend on the terms agreed. A number of factors will affect the price, from the amount of working capital and cash left in the business, to the value of the debtors and stock, and the interest rate on any deferred payments. There may also be VAT and corporation tax liabilities to factor in.

The 'structure' of the deal

The sum ultimately paid on a purchase is often structured, with part being a lump sum and the balance in instalments. There may also be an earn out mechanism whereby the seller is paid certain sums in future if the business achieves stated financial goals.

For the seller, the best deal is likely to be payment of the full amount in cash upfront. For the buyer, that would be the worst deal – they would want to pay as little as possible upfront, and to spread the payments over as long a period as possible. Ideally, they would also link the payments to the success of the business, so as to pay the purchase price out of the profits.

For businesses of a certain size – with a turnover of £1m plus - the purchase price is rarely all-cash: part of the price is always paid later. The higher the upfront element, the lower the overall price. Conversely, the longer the seller is willing to wait for their case, the higher the overall price.

Part of the payment may not even be in cash. For instance, it could be in shares in the buyer company. For the buyer, this is a way of avoiding having to produce a substantial cash sum before purchasing the business. However this has risks for the seller: as minority shareholder in the buyer company, they might face difficulties in selling the shares if wanted to convert them to cash.

Ultimately, the price paid and the deal structure will depend on the respective bargaining power of the buyer and seller.

7. WILL THE SELLER STAY ON AS A CONSULTANT?

It common for the seller to act as a consultant for a few months or even a year after the sale, under a fixed term employment contract. This assists with the smooth transition of the business from the seller to the purchaser, and the buyer can benefit from the seller's experience following completion.

For the seller this can be a satisfactory arrangement – perhaps with reduced hours and fewer responsibilities. However it can also have downsides: they are no calling the shots in the business, and have to accept that the buyer is running things their own way.

The seller should make sure they have a separate consulting or employment agreement. It should define their duties, expected hours and daily rate.

This Guide is for reference purposes only, and does not provide advice for any particular set of circumstances.

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