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Forward thinking

Growth by acquisition

A practical guide for owner-managed businesses

Finding the right fit

Acquisitions can be an excellent means of enhancing shareholder value in a privately owned business. However, selecting the wrong target or not having the range of skills to properly manage the process may result in a golden opportunity becoming a liability. This guide takes you through the key stages of a successful acquisition.

Pre-acquisition planning

Each stage in the acquisition process is crucial to a successful transaction but before you even reach the starting blocks you should ask yourself the question **Why are you buying?**

Acquisition is clearly not the only way to achieve business growth and may actually give rise to a broader spectrum of management problems. It may, however, be a good means of responding to changes in your market, generating cost-savings or providing important integration or cross-selling benefits. In any event, it should be a carefully planned strategy which should articulate what the acquisition is seeking to achieve in order that potential targets can be appraised. It should take into account not only the tangible expectations in terms of earnings but also the capability of people in your organisation to manage the process and the post-acquisition integration without a detrimental impact on your existing business.

Once you have decided that acquisition is an appropriate strategy, the main pre-acquisition considerations include:

Assembling the team

- identifying someone in your organisation who has the right range of skills to co-ordinate and take responsibility for the process, utilising others as appropriate, particularly those with expertise to perform commercial and market assessments;
- considering whether those individuals' existing responsibilities will suffer and who should assume those responsibilities in the short-term: A corporate acquisition is likely to take at least three months to complete and could cause significant disruption in that period;
- selecting and appointing the right advisers from the outset to assist with the acquisition process and to complement the skills and resources of your organisation. This will minimise the disripution to management for the day to day running of your own business.

Appointment of the right adviser will also help you to anticipate potential issues arising in the transaction and prepare accordingly.

Having the right team in place and working closely together with a common and understood strategy is a key feature of success. You need people who are prepared to take decisions and give opinions – particularly difficult when the advice may be to withdraw from the transaction at a late stage.

Tax needs to be considered at an early stage. For example if the acquisition vehicle (AcqCo) is not yet known, it is important that any engagement letter with the advisers allows for the inclusion of AcqCo as a party to the engagement. Failure to do this may mean that some or all of the VAT charged by advisers cannot be recovered, potentially increasing deal costs by 17.5%.

Identifying opportunities

The consideration of a business acquisition will either be the outcome of the development of your acquisition strategy or an opportunity which presents itself to you. In either case it is advisable to research the market to ensure that the target business meets your acquisition objectives. This will require an information gathering process, including:

- financial information;
- press articles and available market information on the companies;
- general market information on the industries and your geographical locations;
- synergies and conflicts with your company and acquisition strategy;
- issues and challenges peculiar to the companies;
- cross-border considerations (where relevant).

It takes time, skill and often a little subtlety to bring together all this information and provide a clear early picture of the challenges and opportunities associated with your targets. Our experience shows that the process often also generates other propositions to consider.

Approaching the targets

In the approach stage the key considerations are generally:

- formulating initial views on valuation prior to discussions;
- confidentiality, with no risk of leaks within the companies or in the market;
- who should make the approach and when.

Using your advisers to provide advice on valuation and to make initial contact may, depending on the circumstances, be the best way forward. This approach has the benefit of maintaining confidentiality and providing an independent view on value.

Negotiating terms

Once the potential vendor has agreed in principle to an acquisition, and after signing a confidentiality arrangement, it is then possible to obtain more information on the target. This should enable you to finalise views on value, subject to any issues which may arise from the detailed investigation process.

Whilst your valuation, and therefore price, is clearly a key factor in negotiations it is important not to underestimate the following:

- the need to maintain goodwill with the vendor throughout the negotiation process. This may cause you to think carefully as to who carries out the negotiations. Personalities can get in the way of good deals. Existing contacts between the organisations may be used effectively but using advisers for the difficult parts of the transaction can help maintain the goodwill. Maintaining goodwill will also help to secure the services of key employees of the target company;
- if your target is an owner-managed business, you may meet resistance from the vendor based on emotional ties. Having built up a business, many vendors are quite naturally concerned about links with customers or suppliers and also about ongoing security of employment for their staff. It is important to allay their fears wherever possible regarding future custody of the business;
- your proposals regarding the future management and operations of the business could play an important part in the negotiations, depending on the vendor's view on the continued participation of himself and senior employees in the management of the business;
- the importance of the vendor to the business should be borne in mind in determining whether the company can deliver the goodwill paid for;
- the vendor's valuation of his business may be a long way from yours. Whilst the vendor may not appreciate synergy benefits or know your future plans he is likely to demand a value for "sweat equity" – the hard work and sacrifices he may have personally made in building up the business – even though the current performance of the business may not justify this. It is important to look at value from the seller's perspective first and negotiate with this knowledge in mind, whilst keeping a clear view regarding the value of the acquisition to your organisation.

Frequently, the aspirations of vendors and purchasers can be very different. Changes in tax law have widened the gap between the preferred tax strategies for vendors and purchasers. Typically vendors aim to maximise their post tax return through share sales, whereas purchasers interests are often better served by asset sales which can allow them to obtain tax relief for a significant amount of the purchase cost. Frank discussions are needed at an early stage in the acquisition process to resolve this potentially difficult issue.

The VAT treatment of sales of assets as opposed to sales of shares also have different risks. Under certain circumstances assets sold as a business can be sold VAT free but there are additional complications where properties are sold that can lead to significant costs if these areas are not considered. Share transactions may crystalise issues relating to the recovery of VAT on associated professional fees.

Honesty, integrity and the ability to sell yourself to the vendor are all key attributes of a successful negotiation process.

It would be normal for Heads of Terms to be agreed at this stage, subject to the investigation stage being satisfactorily completed. The Heads of Terms may also include granting a period of exclusivity to enable you to move to completion unopposed once the substance of a deal has been agreed.

Investigating the target

A detailed due diligence process is not an option but a necessity. You are making an investment that may significantly affect your future business as well as your personal reputation. Regrettably, we get involved in many deals after the event where normal investigation procedures, if undertaken, would have revealed problems and adequate protection could have been obtained. It is important that the vendor appreciates the extent of your expectations in this regard from the outset. Discussion and input by those funding the acquisition is also important before the due diligence process commences.

Due diligence investigations can broadly be split into the following areas:

- commercial/market;
- financial;
- tax;
- legal.

We would generally recommend that your professional advisers are involved in the financial, legal and tax areas. Depending on your in-house expertise, external advisers can also be employed to provide valuable commercial or market insights that may affect your views on the business and the price. However, in depth investigations by your own team on the company's operations, the commercial aspects of the corporation, including people integration, and the market generally are crucial to most successful acquisitions.

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Whilst there is no prescriptive degree of detail attached to the investigation process, it should enable you to feel comfortable with all key aspects of the target's business both historically and in the short-term future.

For example, you would expect the investigation reports, as a minimum, to cover details of unusual items affecting the target, historical and future earnings and its assets, taxation status and legal issues relating to title or litigation. They should also deal with details of employees and terms of employment, financial controls and systems, historical and future capital investment, any unusual commercial arrangements, future cash flow and funding requirements and the availability of adequate finance to take the combined business forward.

Risks arising from the corporation tax, VAT and employment tax history of the acquisition target can be deal breakers. A thorough due diligence exercise is essential to understand and mitigate the risk of unexpected tax liabilities associated with the acquired business.

Our experience suggests that the scope of investigations is widening to include such areas as:

- environmental matters;
- IT systems;
- pension integration and funding;
- production systems and processes;
- adequacy of existing insurance cover, including key-man and critical illness for key employees.

This process normally takes weeks rather than days and involves as much access to the vendor's business as can be agreed, whilst maintaining confidentiality. In particularly sensitive acquisitions the use of advisers can help the purchaser gain comfort from investigations whilst maintaining confidentiality for the vendor of key commercial areas, such as the identity of customers, until a late stage.

Providing no "deal-stopping" issues are unearthed through this process, the investigations provide the basis for the following:

- renegotiation of price if significant issues affecting your valuation of the business come to light;
- appropriate legal protection to be incorporated in the Sale and Purchase contract to cover issues raised;
- careful drafting of the purchase documentation to ensure that adequate legal protection is available to cover any potential tax liabilities arising from the acquisition target's tax history. Agreeing these terms with the vendor can take some time.
- better appreciation of the overall financial commitment required to buy and run the business. This will enable a more informed view to be taken of the financing requirement.

> "Completion is not only the culmination of a successful transaction but also the start of a new phase in the enlarged business."

Steps to completion and beyond

Once the various due diligence procedures are complete and the price is finally agreed, the period to completion is likely to take at least a month. During this time all the necessary legal, and where appropriate financing, documentation will be put in place. For you, as the acquirer, this will be another busy period. In conjunction with your advisers, you will need to address the following issues:

- tax efficient integration of the acquired business into existing operations frequently provides additional cash flow benefits which mitigate the risk of acquisition.
- often, unexpected tax costs in an acquisition can be stamp duty and VAT (on both the sale of assets and advisers fees). Effective planning is required at an early stage to minimise what can be a substantial transaction cost;

- acquisitions may trigger existing incentive plans for key employees. Reappraisal of existing plans and development of new tax efficient strategies can be vital in retaining employees that are key to the future business. Early discussions with management are advisable as negotiations can take time in the latter stages of an acquisition;
- the extent of the legal protection required to cover issues raised, whether these risks can be adequately covered by warranties and indemnities given by the purchaser and whether any consideration should be held back in escrow for matters pending resolution or clarification;
- handling the publicity of the deal to maximise any opportunities created by the acquisition and to minimise any adverse impact on either business;
- securing the support of all employees, particularly those in the new business, ensuring terms are agreed and the risk of loss of key employees mitigated.

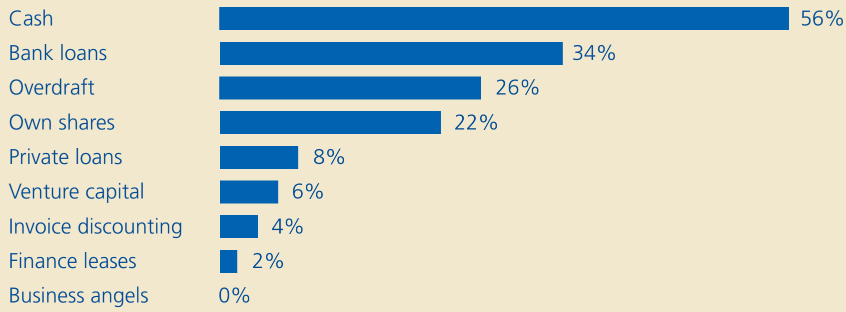
Completion is not only the culmination of a successful transaction but also the start of a new phase in the enlarged business. The challenges ahead are often significant, cultures are different, new strengths and weaknesses come to light and re-appraisals of the newly enlarged operation need to be undertaken quickly and efficiently. A well managed acquisition process should therefore not stop at completion but have an active plan and strategy for the integration and management of the target business following completion. It is often useful to ensure people involved with completing the acquisition are involved subsequently, to benefit from the knowledge, information and relationships they will have developed in the acquisition process. This will provide the best springboard to meet the challenges and opportunities going forward.

To discover the views of growth companies towards acquisitions Deloitte carried out a survey of 50 companies. Our key findings are reported in the next column.

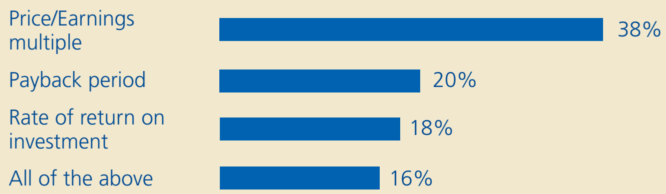
Over 70% of companies considered growth by acquisition to be a viable strategy for their business. The majority of those that did not see it in their future plans were hoping to grow organically. 52% of the companies surveyed had considered between one and five companies for acquisition in the last year and 44% of companies had acquired between one and five companies in the last three years.

Financing

When asked which methods have been used to fund acquisitions the results were as follows:



Approaches to valuation when looking for an acquisition target were:



Identifying opportunities

70% of companies used external sources such as their accountants and solicitors or industry contacts to identify a potential acquisition target. Due diligence accountants and solicitors were rated as the vital external advisers needed during the acquisition process.

When looking for an acquisition target the three most important characteristics sought were:

- being in the same or similar industry sector;
- a strong management team;
- a profitable track record.

The key motivation factor behind an acquisition tended to be to increase market share.

Success rate

The top five factors considered by companies to be key to the success of an acquisition were:

- price;
- research by the management team;
- confidentiality;
- plans for the future of the target business;
- securing employee support.

The two most important factors for post acquisition management were seen to be integration into the group and strong financial reporting.

41% of companies surveyed had formal procedures in place for reviewing companies post acquisition and 50% reviewed them on an informal basis.

One in four acquisitions did not perform according to expectations.

Advice to others...

- first and foremost, before even considering an acquisition, know your strategy and then ask yourself does the acquisition target fit into that strategy?
- take into careful consideration the cultural aspect of an acquisition and the effect it will have on employees;
- it is essential to have the whole management team tuned in to make it work;
- concentrating on the post-acquisition period is vital in breeding success.

How can Deloitte help?

Our approach is to offer assistance at every stage of the business improvement process. This ensures you can access expert help when you need it but also ensures that you don't spend money paying for services that you can perform yourself.

Subject to ensuring safeguards are in place to maintain our independence where we also act as auditors to your business, our advisers can assist you with every aspect of the acquisition process.

Identifying the issue

- Helping you to assess if an acquisition is appropriate to your growth strategy.
- Advising and assisting on the likely impact of an acquisition on your existing business and objectives.
- Helping you to identify and assess relevant opportunities for acquisitions in your desired industry and location.

Quantifying the impact to your business

- Providing independent advice on valuation of the identified acquisition target.
- Helping you to critically assess which parts of the target business support your growth strategy.
- Advising and assisting with raising appropriate finance for the acquisition.

Developing recommendations

- Assisting in target identification and approach, helping you to decide who should make the approach and when.
- Developing your awareness of the likely acquisition process and the timescales involved.
- Helping you to consider all forms of strategic alliance that may fulfil your growth ambitions.

Helping you to implement a strategy

- Helping you to secure appropriate levels of exclusivity and confidentiality throughout the acquisition process.
- Assisting and advising in the negotiation of the Heads of Agreement.
- Assisting you by carrying out appropriate and focused financial and commercial due diligence.
- Assisting in liaising with lawyers regarding the sale and purchase agreement.
- Understanding and mitigating the tax risk in the acquired business.
- Negotiating the tax aspects of the acquisition with the vendor's advisers.
- Minimising VAT, stamp duty and other transaction taxes.
- Tax efficient integration of the acquired business into your existing operations.
- Recovering VAT on acquisition costs.
- Helping you to integrate the new business as quickly and efficiently as possible.

Reviewing the effects of the acquisition

- Helping you to revise and update your growth strategy, post acquisition, as the business environment and your own objectives change.
- Helping you to maintain the support and buy-in of both new and existing employees, especially through the acquisition integration process.
- Assisting you to critically assess the capabilities of the enlarged business and helping you identify any areas of financial or management weakness.

Monitoring the future health of the enlarged business

- Assisting you with the comparison of the performance of the new business with those in your industry and your competitors.
- Helping you to stay alert to business issues which may impact on the successful integration of the acquisition and the future effectiveness of the new business.
- Helping you to identify future growth opportunities as your business and market conditions change.

For more details see www.deloitte.co.uk or email: omb@deloitte.co.uk

Deloitte & Touche LLP is a limited liability partnership registered in England and Wales with registered number OC303675. A list of members' names is available for inspection at Stonecutter Court, 1 Stonecutter Street, London EC4A 4TR, United Kingdom, the firm's principal place of business and registered office.
Tel: +44 (0) 20 7936 3000. Fax: +44 (0) 20 7583 1198.

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