finnCap CAVENDISH

Weighing the options

Trade vs PE sale

So you've decided you want to sell your business. No doubt this has been one of the hardest decisions you've ever made. The next part is certainly easier, but you need to get it right – deciding which exit route to go down. This decision is about more than realising value, it also takes into account your objectives for the future and whether you (and your other stakeholders) still want to retain any part of the business.

In principle, there are three main avenues open to you at this stage: trade sale, a full or partial sale to private equity or an IPO. For the purposes of this article, we'll be looking at the first two – why you might choose them and what to expect. But first, let's cover a few of the reasons you might be seeking to sell, as this will have an impact on the route you choose.

There are myriad reasons why you might consider exiting your company. The most frequent reason for considering an exit is to realise capital, either for financial security or to invest in other projects. There is, however, rarely one reason alone, but generally a combination of the following:

- The recognition that the business has reached a peak or a target valuation.
- The realisation that the business cannot grow further without a significant capital injection.
- The need to access new markets by being part of a larger, possibly international, group.
- The business has reached a size where the owner feels unable or unwilling to manage it.
- A disagreement among shareholders means that the business is no longer manageable under existing ownership.
- An imminent retirement/succession issue.
- An approach has been received from a credible buyer or buyers of the business.

It is important that you not be coy about the reasons for seeking an exit. It will usually be one of the first questions asked by a potential purchaser and a reluctance to answer the question may make the purchaser suspicious.

Is an exit actually viable?

Before you look at the various exit routes available to business owners, you must first determine whether any form of exit is viable. An exit may simply not be possible for a number of reasons. For example, the business may be totally dependent on you or a single customer, or the business model may be fatally flawed as a result of market or technological developments (e.g. Blockbuster, Woolworths, etc). Alternatively, the company may operate in an industry which is in terminal decline. Clearly some of these impediments to an exit can be remedied while others cannot. There will also be situations where a sale may be a viable option but the likely valuation would be so low that it would not be in the owner's interests to sell. In that scenario, the best option may be to continue to own the business and retain the dividend stream.

Determining the right exit route

If you're satisfied that an exit is possible and you want to go ahead, it's time to think about how you're going to do it. Each option has different implications in terms of how much cash you can realise, and how much on-going involvement you will need to have with the business post sale.

Sale of Hancocks to H2 Equity partners

- Specialist confectionery wholesaler sold in a management buyout backed by Netherland based H2 Equity Partners
- Hancocks has 18 cash and carry depots across the UK, with turnover of some £100m
- Its specialism is buying confectionery in bulk from a range of suppliers and then selling and distributing these to customers at a profit
- Had engaged PwC (their auditors) to perform a sales process exercise which failed
- Suggested to Hancock brothers to try other avenues that had not been explored: international trade and private equity
- Had to transform the company into a deal that private equity would support
- The deal closed, achieving a valuation far in excess of our client's initial expectations

"This is a cracking result for both the Hancock family and the management team. You did a fantastic job balancing out the issues that might otherwise have arisen and achieving a deal that works for everyone"

Mark Watson, Managing Director

Trade Sale

If you're looking to take all of the cash out of the business and leave completely, a trade sale offers the best opportunity to do that. This is particularly true if the trade buyer is a competitor as they will likely absorb your company into their organisation and you can completely walk away.

However, when the business remains heavily reliant on you at the time of sale, an earn-out structure will frequently be required to enable the acquirer to retain you and key management to deliver performance after the deal. In that instance, total cash out will not be achieved until the end of the earn-out period. Devolution of management responsibilities in the lead up to a sale will mitigate the need for an earn-out or, at least, reduce the earn-out period or quantum.

Other features of a trade sale are a typically less onerous due diligence process compared to a PE transaction, and the fact that ultimate control of your company will be transferred to the new owner. A trade sale will also typically offer less equity upside to the management team. However, in some trade sales (such as the sale of Marsh & Parsons to LSL) deals have been structured with elements of a private equity transaction to allow the management to profit from further equity upside.

Private Equity Transaction

A transaction with a private equity house will often involve a partial sale as management shareholders will typically be asked to reinvest a proportion of their sale proceeds, into the acquiring company. If the owner/managers have replaced themselves with a top management team which has been performing well in the business for at least 12 months prior to a sale, there is the possibility of a clean exit or at least one involving a minimal reinvestment.

A private equity transaction suits an owner manager who wants to de-risk his wealth position by taking some money out but would like further investment to expand aggressively (organically or through acquisition) in order to build a much larger and more valuable business. If this strategy is effective, the value of the owners' residual shareholding will be significantly enhanced on a subsequent sale of the company.

The structure of such a sale will generally involve an element of bank debt to enhance (or gear) the returns of the private equity house and if you are considering this exit route (and retaining an equity stake in the business) you need to be comfortable with the risks which taking on bank debt entails. Analogous to a private equity transaction is a sale to a HNWI or family office. This has become a much more prevalent exit route over the last few years.

Preparing your business for your chosen exit route

Once you've made the decision, it's time to start preparing the business for sale. Each exit route will have its own unique requirements, so it's good to keep these in mind as you're going through the process of choosing. That said, it is possible to prepare the business for both options – we'll come back to this.

Trade Sale

For a trade sale, it might make sense to start a commercial dialogue with a number of potential purchasers (particularly potential overseas acquirers) so you can get to know each other well in advance of a sale process. In certain cases, commercial agreements with an ultimate buyer have been put in place long before a sale.

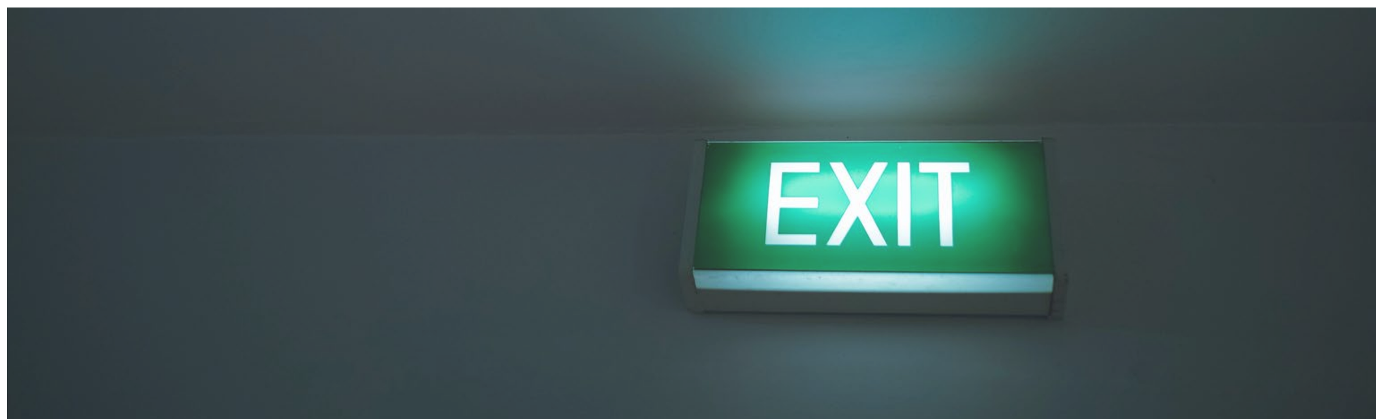
In addition, it would make sense to monitor the key potential buyers and their acquisition strategies. Large corporates tend to work to their own time agenda so you might be perfect for them this year but not next year when you want to start your sale process.

Private Equity sale

A private equity sale typically requires more detailed planning than a trade sale and should particularly focus on these six key areas:

- A clear idea of the management team which a private equity house will back - whether it be yourself and the existing team, or a management buy out (MBO) involving just your existing team. If an MBO is proposed, you need to be confident that the team is backable by private equity;
- A robust three year business plan based on growth platforms which have a proven track record. If the plan involves a buy and build strategy, a track record of successful acquisitions will be important. If the growth strategy is a roll out model of additional sites, the model needs to be proven;
- A detailed monthly management accounts pack which has been prepared on a consistent basis ahead of a sale and is available on a timely basis following month end to evidence trading versus budget;
- An understanding from the banks as to how much debt they would be prepared to put into the transaction. This is normally a multiple of EBITDA and is typically in the 2-3x range currently;
- Integration of the business plan and likely deal structure (including bank debt) into a Leveraged Buyout (LBO) financial model to ensure that the PE house's multiple of its original investment on a 3-4 year horizon is in an acceptable range, typically 2-3x;
- A view on what will be the ultimate exit strategy for private equity as they will need to be assured that they will have an exit at the end of their investment holding

Typically, private equity firms will evaluate potential acquisitions against various quantitative and qualitative criteria such as: differentiated position, market attractiveness, growth prospects, the level of recurring revenue/repeat business, the experience of the management team, defendable IP, brand strength and barriers to entry. If you are looking to pursue a private equity deal, you will need to ensure that your business will be evaluated positively against these criteria.



Conclusion

This is a big step, so it's important that you have considered your options, thought long and hard about your objectives and which exit routes suits those. With the decisions made, it's time to get ready. While it's good to have a plan for how you want to exit, the various exit routes are not all mutually exclusive. If you'd like, you can pursue a twin track sale process which will involve approaches to both private equity and trade buyers. It is also possible to twin track a sale route and IPO although the high costs of doing so only make it appropriate for select businesses. Even then it is usual, following initial market soundings, to identify one route as preferred.

But remember, whatever happens, shareholders need to be aligned on the chosen exit route. Don't let miscommunication get in the way of your successful sale. With everyone aligned, you can realise the potential of your hard work.

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