CLAYTON UTZ

Selling a privately-owned business: getting ready for the big offer

You're a private business owner who's been running a business for some years. It's a terrific business that generates good profits, doesn't demand heaps of capital and is well run. You think (as much as you really can ever think this) that you are on top of running the business after all this time.

Then, out of the blue, you receive an offer for the business from an international group in your industry that's looking to establish a presence in Australia. Recent research suggests that despite our high dollar, international buyers tend to pay higher multiples. Or, it could be a private equity buyer that's been scouring the market and spotted your business.

The offer proposes a fantastic price; materially more than you thought your business would be worth. But this offer is only open for acceptance for the next two weeks and the sale will need to be fully transacted (that is, due diligence materials assembled, due diligence and management presentations undertaken, all documents drafted and negotiated, then signed and completed) within the next two months.

A business that is poorly prepared for sale can mean the loss of significant value. Often, that value can be readily preserved, if private business owners identify the issues, have a plan to address these and some time to implement their plan. Overall, preparation equals value.

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What does a buyer look for?

To maximise value, a buyer must be convinced of the worth of the business. What works well to generate good cash flows and good profits when running a business, while obviously important (indeed, fundamental) in the sale context, are not the only things that are important in order to maximise sale proceeds. Privately-owned businesses in general have a credibility problem in the eyes of the sorts of buyers they are likely to encounter, who can think that the business may:

- not rigorously prepare its financial information;
- not have proper asset management and risk procedures, so there is a greater exposure to risk;
- have more lax employee procedures; and
- not be properly separated from the owner's personal affairs, so private expenses might be run through the business, and there might be some concern about tax compliance and risk.

Common problems – and solutions

Intellectual property

Problems with intellectual property are very common when it comes to selling privately-owned business. Examples include:

- not having a strong, independent brand, so that the business is too closely identified with the founders, reducing value to potential buyers accordingly;
- not dealing expressly with the ownership of copyright in agreements with contractors who have created critical marketing tools of the business, such as catalogues, a logo or website, or a critical piece of software for the business which now provides a competitive advantage;
- not registering intellectual property, such as a domain name, logo or brand; or

- not properly acquiring intellectual property.

Solution: Owners should review their intellectual property portfolio now. They might need the co-operation of a counterparty who may have no inclination or incentive to assist and may indeed take advantage of the situation, but it is better to solve it now.

Being aware of a problem will also enable a business owner to maximise the chance of resolving it, by picking the best time to seek counterparty cooperation, for example when a contract is being renewed or new work awarded.

They should also review their contracting arrangements to ensure that future intellectual property is clearly theirs.

Business structure

A business' structure often reflects how it has been built up over the years, influenced by the then prevalent tax or succession planning solutions, and become unwieldy over time and not readily transferrable to a buyer.

For example, a company runs a number of businesses, but buyers are likely to only be interested in one of them, not the whole package. Practically speaking, the only way to sell is by a business sale. However, in certain situations selling in that way could present a serious problem.

An example is a strata management business which in essence comprises a large number of separate management contracts with the relevant bodies corporate. All of these need to be assigned to the buyer. Under the strata title legislation, each assignment requires the relevant body corporate to convene a general meeting to provide consent. A buyer would only be prepared to pay for the management contracts which are actually transferred. The seller is at the mercy of all those body corporate general meetings – not a great place to be!

Solution: Prepare the business for sale over time by transferring each separate management contract to a subsidiary that only undertakes that business. This could be done as the AGM for each body corporate rolls around. Then, once all the management contracts have been transferred to the subsidiary, the business is readily saleable because all that is required is a sale of the shares in the new subsidiary.

Your business structure might be useful to you – but not to a potential buyer.

Key contracts

Perhaps for historical reasons or inadvertence, a key customer contract, critical to the revenue and profitability of the business, may not be in the name of the party that now operates the business. This might not be a day-to-day issue for a private business owner, but will be a problem upon sale, especially if it's done as a share sale.

Key contracts can present other issues – basic ones such as whether they are written, whether they are they signed and when they expire, and more major ones, such as whether a major contract can be disclosed to a buyer and if so, when. If the buyer is a competitor of the other party to the contract, can the contract be assigned to the buyer?

Solution: These issues can be readily identified and a plan developed to rectify ahead of the sale process commencing.

Once any issues are known, a private business owner can select the most appropriate time to request the co-operation of counterparties – this may be at the time of contract renewal or when the counterparty approaches the business owner asking for a favour or allowance.

Employees

Often private business owners take a basic approach to employee issues because they have good relationships with employees and know most of them personally – none of which will be available to private-equity or corporate trade buyers.

So the business might not have policy manuals for dealing with employee issues, or processes and policies to address statutory requirements. Employment contracts might not contain appropriate restraints upon some of the more critical employees.

Solution: A privately owned business can readily address this through some simple steps – review template contracts and create or update employee procedure manuals and policies for current business risks (OH&S, competition from departing employees, preservation of confidential information, etc) and changes in legislation. If contracts for current employees need to be varied, then often it makes sense to do so at annual review time, when pay increases or other incentives can improve the likelihood of acceptance.

Litigation

Although a buyer can avoid taking on the potential liability under any litigation that is on foot by acquiring the business and assets, rather than the shares in the company that undertakes the business, any unresolved (or recently resolved) litigation will likely still concern potential buyers.

Litigation can be an indicator of some systemic issue in the way the business is run, which could mean further litigation or costs to change the system. This is so even if the business is suing, rather than being sued.

Solution: Owners should resolve any outstanding litigation and be prepared to explain how the underlying circumstances that led to the litigation will not recur. It is best to have a year or two between the resolution of any material litigation and a business undergoing buyer due diligence ahead of a sale.

Data room preparation

If there are gaps or errors in the documents, the owner loses credibility and buyers have the opportunity to leverage off this to argue for a discount.

Solution: Loose ends such as unsigned critical contracts should be signed and the inevitable errors (often minor) that might show up in a hastily-assembled data room should be identified and addressed.

Getting the governance right

In some privately-owned businesses, increasing the level of formal governance can assist in reducing risk, identifying issues that might emerge upon a sale and generally enhancing the credibility with which the business presents itself to potential buyers.

Perhaps even more powerfully, governance is a means by which, both in fact and in perception, a business can present as less dependent on the involvement of its founders than it would without governance. This can add very significantly to value.

Often, formal governance policies and procedures are not required and may not be of much value when running a privately-owned business. Many private business owners think that the absence of governance procedures makes them more flexible, more adaptable and more opportunistic. That may be so, but the benefits of that should be weighed against the benefits of formal governance when planning a sale.

Credible corporate governance can add very significantly to the sale value of a privately-owned business.

Achieving greater formality in governance

There are a range of ways to adopt some greater formality in governance:

- without changing the make up of the board of a company, the company could implement a more structured system of monthly meetings. These may or may not be formal board meetings, but should nonetheless involve the directors and those who report into the CEO;
- a company can set up one or more committees. These can be formal board committees or more informal, but they are set up to address areas of need, to bring in expertise and focus on how risk management can be improved and issues for the business addressed. Examples are an audit and risk committee, a brand development committee and an employee policies committee, to assist in developing those aspects of the business in readiness for sale. These committees might have outsiders on them and they might not, depending upon the need and the expertise available in the business;
- an advisory board could be established. Properly structured, members of an advisory board will not carry director duties and liabilities and this can be a sensible stepping stone towards a more fully independent board;
- one or more outsiders can be brought onto the board. This can be very beneficial, but it needs to be right for the business; and
- governance can also be improved by developing appropriate governance policies and procedures.

Corporate buyers and private equity see many poorly organised privately owned businesses. They will take the opportunity to highlight the possible risks to them in undertaking an acquisition of a poorly organised or more risky business. Some investment in governance can dispel most of these apprehensions, and allow private business owners to defend the level of risk in the business and so achieve higher value for a seller. Nonetheless, formal governance should be introduced carefully, to ensure the owner's ability to drive and control the business is not unduly impeded.

Value loss after the sale contract

The issues raised so far have largely been about loss of value before a sale contract is signed (a reduced "headline" sale price) arising when possible buyers consider the business presents inappropriate levels of risk. Businesses also risk losing value after the sale contract is signed.

A data room and business that present well build confidence, which will mean that:

- owners are likely be able to negotiate a reduced post-completion retention. The more risky the business appears, the longer the period of the retention a buyer will seek, and also the greater the proportion of the purchase price;
- the claim period in the sale agreement can be reduced;
- the buyer's perception of risk will be reduced, so value will be protected or better able to be defended; and
- finally, the risk of errors or omissions will be reduced, and thus the direct risk of a claim for breach of warranty or a claim for misleading or deceptive conduct under the Australian Consumer Law.

Solution: As with issues before the sale contract, risk after the sale contract is best addressed with a plan and a process to follow through on the plan.

Contact

Nick Miller
Partner
Corporate Advisory / M&A
T +61 3 9286 6190
nmiller@claytonutz.com

Sydney
Level 15
1 Bligh Street
Sydney NSW 2000
+61 2 9353 4000

Melbourne
Level 18
333 Collins Street
Melbourne Vic 3000
+61 3 9286 6000

Brisbane
Level 28
Riparian Plaza
71 Eagle Street
Brisbane Qld 4000
+61 7 3292 7000

Perth
Level 27
QV1 Building
250 St. Georges Terrace
Perth WA 6000
+61 8 9426 8000

Canberra
Level 8
Canberra House
40 Marcus Clarke Street
Canberra ACT 2600
+61 2 6279 4000

Darwin
17-19 Lindsay Street
Darwin NT 0800
+61 8 8943 2555

Hong Kong
703 - 704
The Hong Kong Club Building
3A Chater Road
Central Hong Kong
T +852 3980 6868

www.claytonutz.com