THE DEALMAKER

THIS MONTH:

Disposals have been tough going of late. But with buyers coming back, values up and a need to restructure for the upturn, it might be time to brush off the divestment strategy, says Richard Young.

STAND BY TO SELL

THE RIGOURS OF a sluggish economy have probably had you looking carefully at your business's structure. Which bits are doing well? Which have been exposed as fragile or non-core? Trouble is, selling an unwanted division, subsidiary or even the whole business is probably a bad call for shareholders when the market is weak.

Simon Tinkler of Clifford Chance: steadier results and higher profits are boosting acquirers' confidence

But the numbers seem to be on the move (see graph). "The tide does appear to have turned," says Jeremy Furniss, partner at adviser Livingstone Guarantee. "And there's a pent-up need to make disposals by companies, owner-managers and private equity firms many of which have pretty much been waiting since late 2001 to make an exit."

The key, of course, is having acquirers looking for deals. "We're expecting an increase in the number of financial buyers coming out of the US for the larger deals," says Simon Tinkler, a partner at Clifford Chance. "But trade buyers are also making a come-back. Steadier results and better profitability mean they're willing to buy."

"There's more appetite amongst trade buyers than there has been for a while," says Furniss. "The last couple of years have been great for teams looking to do MBOs because corporate vendors didn't really have any other choice. But there's an increase in confidence amongst purchasers."

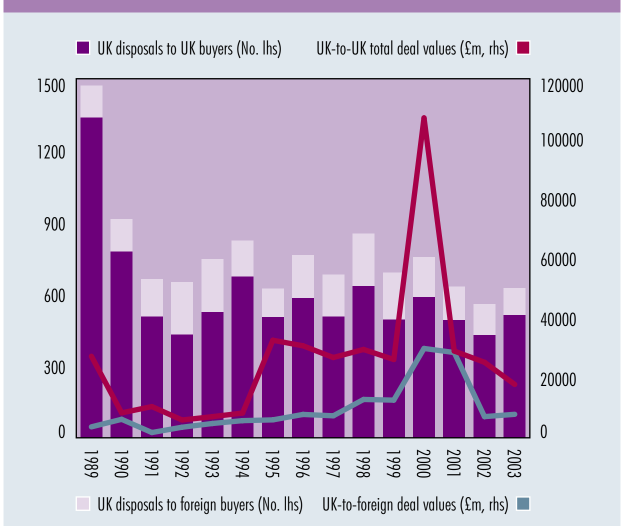
You still have to find a buyer for your own disposal, of course. At the moment, financial buyers look a good bet. Private equity firms have been rebuilding funds, so they need fresh targets to chase. "Trade buyers can be less stable," says Tinkler. "They'll also focus on different areas. They might be more interested in patents or market share; a financial buyer looks primarily at cash flows."

But you have to look beyond market conditions when it comes to disposal decisions. "If your advisers are saying there's a lack of appetite for the business, it may be better to postpone sale plans," says Simon Lord, director of investment bank Altium Capital. "Preparation and planning well in advance are key to ensuring that your business achieves its optimum value. That's likely to be calculated by reference to a multiple of your historic or forecast financials, so you must drive hard for profit before you initiate a sale."

There are other considerations. "An important factor is the time of year you plan to make the disposal," says Tinkler. "You might want to avoid, for example, trying to do a deal around the same time as the audit. And if you have a US listing, it's wise to steer clear of quarterly reporting season when you're closing a deal."

If timing is a factor, you'll need to keep an eye on the timetable. "Despite higher confidence levels, we haven't yet seen any great urgency in terms of getting deals done," says Furniss. "At the last peak in the M&A market, we were seeing deals taking between five and six months, start to finish. In late 2002, that had stretched out to around nine months. Today, you're probably still talking about seven or eight months to get your deal signed off. Confidence does have further to go."

HAVE DEAL VOLUMES BOTTOMED OUT?



Source: National Statistics

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SELLING UP, NOT SELLING OUT

You need to make sure that you, the team you're selling and the buyer are all happy when you sign off your disposal.

Name: Jeremy Rayment
Vendor: Barclays Ventures and management
Disposal: TM (a design agency in the entertainment industry)
Acquirer: AGI (division of MeadWestvaco, an NYSE quoted group)
Value: N/D
Legal adviser: Lawrence Stephens

COMMENT: "I was an adviser on the original MBO of TM when management bought out the founders, a husband and wife team. I'd helped out raising equity and debt capital, and when we were putting the strategy together it became clear there was a need for an FD. So I stepped in.

"Because it was an MBO situation, we knew that we'd be looking to sell the business. So you're always looking to make the business attractive to potential acquirers. You also work to understand the supply chain you're in very well and have a clear idea how the business might fit into it. Knowing your potential acquirers will help you mould the business to make it an easy fit for them.

"A lot of that was regularising the business, making sure our contracts were clean and standardised, that all our employment issues were clear and the operation looked slick. We also made sure that there were good systems in place. Partly because I'd been an adviser, I had a clear idea of which parts of the business were going to be looked at during any due diligence process.

"Understanding the value of the business you're selling beyond the p&l is crucial. Unless you know what the acquirer lacks, it's easy to underestimate the true value. We had one particular buyer marked out, and we made sure that we worked with them on a couple of projects so that they properly understood the synergies. As a manufacturer further down the supply chain, they didn't have much access to the ultimate clients (film studios, for example). So it was obvious that by buying our business, the value they would enjoy would be way beyond a simple multiple of our annual profits.

"Once we'd got to know each other, it was a question of getting the principals together and talking about how we could take the relationship forward. Then you're on to price. In our case, the buyer came back from discussing the deal with their head office in the US with a number based on our p&l. Our job was to convince them that there was another value based on their ability to enhance their route to market. Playing hard to get in these situations isn't a bad thing.

"The due diligence was very taxing. As FD, you're the focal point of that process. And you have to keep the business running. You're project managing the deal, but you've also got to help the rest of the management team stay focused on the business. I was lucky in that I had someone in my team who was managing the operational finance matters.

"The timetable will inevitably slip. In this deal, the due diligence overran and we spent a lot of time waiting for the acquirer to have conversations with their group board over in the US. You're also engaging in considerable debate and negotiations on the legal documentation, particularly warranties and disclosures. The last two weeks are very emotionally intense. Then comes the completion evening with all parties, lawyers, financiers, management team – everyone wants their final say, and as FD you do find yourself trying to balance the whole thing out. It was an enormous relief when it was all over. You're constantly feeling the sense that it is your responsibility to ensure that the deal will not falter at any stage. Maintaining momentum and keeping open lines of communication throughout is critical.

"The hardest thing in this deal was having such seasoned acquirers on the other side of the table. It took us a while to adapt to their very robust approach once we had agreed heads of terms and started the negotiations on the legal contracts. Their chairman's opening line was, 'He [their lawyer] and I have done over 100 deals together, and we know what we're about.' Until then, our discussions and relationship had been with a number of other people within the acquiring group, so we had to adapt our style and build the relationship fairly fast with the negotiating team.

"My advice? Talk to someone who's done it before. Even if you know how the process works. I'd done plenty of due diligence for clients when I was advising, but I'd never actually experienced it first hand."

"EVERYONE WANTS THEIR SAY. AS FD, YOU FIND YOURSELF BALANCING THE WHOLE THING OUT"

Jeremy Rayment went on to be FD for the acquirer's UK operations and is now a partner at advisory firm Magus Partners (www.maguspartners.com)

"REMEMBER: YOU'RE IN FOR SOME EXTRAORDINARY WORKING HOURS"

COMMENT: "The Interpet business had gone from £5m turnover in 1997 to £20m and it began to distort the shape of the group. So we sold it to a Californian quoted company, although I'm not sure I'd ever sell to a US company again! There's just such a culture and vocabulary difference. It was pleasant enough doing a deal with them, but very protracted. The deal took about seven months all told.

"They sent over a draft contract that might well work fine over there, but it just wasn't usable for us. Part of the problem is that they don't have the principle of *caveat emptor*. So the contract terms needed a huge amount of knocking down until we could find common ground. I know that this situation wasn't unique to us. But that didn't make our own experience any easier!

"The American acquirer is a $800m market-cap quoted company, it's not some small outfit. But I'm amazed they get any deals done. When we were negotiating this deal, they were concerned about so many different aspects – the health and safety situation, environmental standards, employment law. They were buying a business with virtually no risk attached, but they really went down to incredible detail, clearly fuelled by the onerous post-Enron corporate responsibilities which put unreasonable and enormous pressure on management to ensure the minimum of risk. They also wanted indemnities, guarantees and warranties for everything that might happen to the business in the future that could, in any way, be rooted anywhere in the past ownership.

"The disclosure bundle ran to seven huge cartons, a pallet-load of documents. We reckon it was about a ton of paper. Just the index to the disclosure documents was 110 pages long. We'd never seen anything like it. Again, it wasn't that difficult. It was just incredibly time-consuming.

"The deal was arranged pretty discreetly. All the cloak-and-dagger stuff at the beginning – before we could bring in the management team – went smoothly. Handling the team is crucial. But one typically US thing was the executive contracts. None of my managers have them. I find them too restrictive both on us and the managers, so it's been years since we've used them. But the buyers wanted to lock in the senior people. They asked whether the management team would sign up, and I said I'd happily show them the contracts. Over came these 100 page agreements that included all sorts of rights over the managers' terms of employment.

"That was completely impossible, although I had sent them a typical UK executive contract – but they wanted to stick to their version. So we just had to explain that with TUPE, what they were asking for just wasn't possible under UK law.

"Another complication was that they were buying a business operating in Europe, but applying US valuation methods. We did try to emphasise that it was possible to value companies differently in the UK – just the difference in businesses taxes makes it a different process – but getting them to listen was tough.

"I'd say one of the biggest tips is making sure you have a proper interpretation of the asset purchase agreement. If there have been big earn-outs in the deal, you really have to go through it with the lawyers on 'what-ifs'. We've been caught out before now on >

Name: Peter Lawrence
Vendor: Lawrence plc
Disposal: InterPet
Deal value: £15.8m
Legal adviser: Jen Woodward at Haarmann Hemmelrath

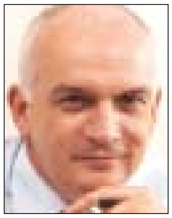
deals where the wording on the earn-outs was slightly odd and we've lost out financially. So now we put a lot of onus on the lawyers. We've been using the same lawyer for 17 years.

"Just remember: you're in for some extraordinary working hours on the way, especially with different time zones. Working day, night, weekends and holidays – they just don't seem to count over there!"

Peter Lawrence, chairman, Lawrence plc

"THEY KNEW IF THEY OWNED THE BUSINESS, THEY'D GENERATE MORE VALUE"

Name: Patrick Shanley
Company: Acordis
Disposal: Acordis Speciality Fibres' (ASF) Hydrocel business
Acquirer: ConvaTec (a subsidiary of Bristol Myers Squibb)
Value: £150m
Legal advisers: Clifford Chance



COMMENT: "We're backed by private equity and came to the conclusion some years ago that our slogan should be 'to find the best industrial homes for our businesses'. We're really a conglomerate and there's little synergy between the businesses we own – although there certainly is empathy between the different management teams in the group.

"So we've been active in divestments for about four years. In this deal, the acquirer was a customer of the business. We'd had on-off, very low-key discussions with them for a while about whether they'd like to buy it. The management of the acquirer saw that it would be a good deal for them in terms of product and market synergies. They knew that if they owned the business, they'd be able to develop products quicker and generate better value.

"It was their persistence that eventually persuaded their owner, Bristol Myers Squibb, that it would be a good deal. They saw that the technology was promising and that buying it now was a good deal and probably more cost-effective than acquiring product from us over several years.

"The deal really started in earnest 12 months ago. In fact ConvaTec had been performing very well, and probably felt able to make the acquisition 12 months before that. But for reasons related to wider group issues, it wasn't the right time. So when the decks were cleared, they were keen to get things moving.

"Despite our divestment strategy, we don't believe in dressing a business up for sale. We like to behave as if we're long-term owners of a company. Apart from anything else, you might not sell it, and then where would you be!

"We did do sell-side due diligence – we used PwC for that project – so all the financial DD was dealt with. We also used an environmental consultancy to clear up that side of things. Then we have a standard sale and purchase agreement that we tailor to each individual deal. It was slightly easier in that we were selling the business to one of its customers, who knew it well already.

"One of the trickier things was that we were going to end up discussing the margins of a business with one of its customers. So we made sure that we finalised all the major contractual issues before we went in to negotiate the price.

"One of the great things about this deal was the relationship we had with the acquirer's management team. They were very thorough, very professional, they understood the business really well and took a very balanced view of the contract. It also meant that we could talk through any problems that came up with them quite easily and get them sorted out.

"When it came down to the last half-dozen issues in the contracts, we got the two principals together, agreed the points and then brought in the lawyers on a conference call. We told them we didn't want to hear from them until everything was sorted out, and I think that helped ensure that the deal didn't drag too much. We also have an in-house lawyer and an M&A guy, and that helps.

"Because we're VC-backed, most of the management teams are equity shareholders, so they have an incentive for the deal to be successful. They put a huge amount of effort into making it work, and without them you'd never get the best deal for all parties. We also recompensed them for the extra work they put in for the deal while they were still keeping the business going. We were also lucky that we were selling to their preferred buyer anyway.

"Another high point for me was solving the problem that arose when the OFT referred the deal to the Competition Commission. The deal was referred over what was actually a pretty insignificant part of the business – most of the value was in a different part of the operation. Whatever people say, the amount of information required during an investigation by these types of authorities is horrendous.

"Doing a disposal deal is much easier when you've got a buyer who's done a lot of deals. It's great when they know what they're looking for. Otherwise, as the vendor, you can get really snowed under by question after question."

Patrick Shanley, CFO and deputy CEO, Acordis

DISPOSALS LESSONS

There's no substitute for good planning when you sell.

1 Get the business in shape. This is particularly important just now. "Coming out of a downturn means that sales growth may not have been that impressive for the business you're trying to sell," says Jeremy Furniss at Livingstone Guarantee. "You have to prove that it has not just turned the corner – it should be clear that it's solidly on a growth curve now." And if the division or subsidiary has been restructured, it may have hefty one-off numbers in the books for the last year or two. You need to strip them out so the buyer can see underlying performance.

"You also need to be able to show you've got a structure that will look sensible to any acquirer," says former FD Jeremy Rayment. That means having easily integrate-able systems, processes and contracts. "If they're experienced acquirers, they'll use anything non-standard to beat you down on price."

2 Get good advice. "Having great advisers is a must," says Rayment. "Even if – as in my case, as an adviser-turned-FD – you may well be able to do most of the tasks yourself, you're too close to the situation. Having a third party adviser, who is emotionally uninvolved, is a deal winner."

Peter Lawrence – who's used the same lawyer for 17 years, even when she's moved firm – agrees. "Another good tip is to tell them what you want and let them do the leg-work," he says. "You don't want to have to read every 200 page document that gets sent around during the deal. And the deal documentation is getting bigger. Twelve or 15 years ago, the basic contract might be 30 pages long. Now you're talking hundreds of pages."

"You should also make good use of your corporate finance advisers before you even start the process," says Simon Lord, director of investment bank Altium Capital. "They'll be able to advise you on the saleability of the business, the likely deal value and the companies that they feel would be serious buyers."

Simon Lord of Altium Capital: get your advisers to work finding buyers

3 Know your buyers. If you're actively selling a business, look for potential acquirers within the same supply chain. You'll know how they operate and can tailor the sell – and the potential synergies will be more obvious to them. But there are other considerations when you're assessing buyers.

"Look at the Debenhams deal last year," says Simon Tinkler, partner at Clifford Chance. "Running a second buyer in parallel, even if you have to pay them, is a good tactic. Break fees and inducement fees on the table do a good job of incentivising bidders to stay in the game." Like everyone we spoke to who'd done a cross-border disposal, he says US buyers can be tricky. Even in domestic deals, your choice of buyer may bring regulatory problems. "But it doesn't have to be competition issues," he says. "If your buyer is listed, bid speculation can cause their share price to fall, for example. So when you get a buyer lined up, it's important to get the transaction done as soon as possible."

> "IT'S IN EVERYONE'S INTEREST FOR EVERYONE TO BE HAPPY WITH THE FINAL DEAL"

4 Be honest. "Getting the warranties sorted out is all about how well you know the business you're selling," says Acordis CFO Patrick Shanley. "And full disclosure is the best form of protection. There's no point in assuming the buyer won't come across certain issues during the course of the deal. So get it all out in the open before you start discussing price. Once you're into that phase, new disclosures are only going to move the price downwards."

5 Do vendor due diligence. "The due diligence process is ball-breaking, especially for the FD," says Tinkler. "You're obviously first in the firing line on financial due diligence. But you're also probably the fount of most knowledge when it comes to contracts and other arrangements that will be material to the running of the business being sold. And you'll probably also have to handle much of the negotiations of the disposal itself. Vendor due diligence does short-circuit some of those problems that can hit disposal deals."

That's a view shared by dealmakers themselves. "We did do sell-side due diligence through PwC, so all the financial side was dealt with," says Shanley. "We also used an environmental consultancy to clear up that side of things as far at the acquirer was concerned."

6 Is everyone happy? "That's one of the big things," says Lawrence. "It's absolutely vital that everyone is happy with the deal when they come to sign it off. You really don't want people reaching for the small print in the agreements or warranties as soon as the deal is done. We want the business to do well under its new owners – and we may want to do business with them ourselves in the future, so it's in everyone's interest for everyone to be happy with the deal."

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