Chartered Accountants
& Business Advisers

Extracting **value** from **your business**

a guide to exiting your company on your terms

Foreword

Leaving your business should be a well considered and planned event in order to maximise the value of what you have built.

While this guide focuses on the issues for business owners, there are common themes that cover all aspects of business, whether that is professional practice or complex businesses operating in the healthcare sector.

I trust you will obtain some value from this publication and that it will get you thinking about some of the issues regarding your own business.

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preface

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Introduction

There comes a time when every owner leaves their business. However, few plan properly for succession or an exit on their own terms. It is estimated that only seven per cent of business owners have taken steps to plan their ultimate exit. This is despite 45 per cent saying they want to retire before they reach 50.

This PKF booklet provides information on exit planning for the apparent majority of business owners who are currently avoiding the inevitable. It also outlines the main routes available to potential vendors.

It is never too early to start thinking about exiting your business. In fact, you should consider exit planning in your original business plan and this exit planning strategy should be revisited throughout the life of your business.

Succession and exit planning is not a single event but a deliberate, tailored process that requires planning, teamwork and constant re-evaluation.

A benefit of the exit planning process is that it can help you to identify and set your personal and financial goals as well as how best to achieve them. An exit plan can also help to maximise your financial return when you transfer your business, while minimising your tax liability.

Your planned retirement date may still be a long way off. However, understanding the process now can help you run your business in a way that will make it easier to leave and ensure that it is in optimum financial shape when you are ready to exit. A more fatalistic but prudent reason for exit planning is that it can help to ensure that your business survives and that your family receives its full value if you die or become unable to run your business before retirement.

There are a number of exit options to consider. These include the following:

- A trade sale;
- Handing over ownership to offspring or other relatives;
- Passing control to a non-family manager or management buy-out (MBO) / management buy-in (MBI) team;
- Stock market flotation; or
- A voluntary liquidation.

Unfortunately, many owners follow a "keep going until you drop" approach. This is the worst possible way of leaving your business. If you suddenly decide that you want to leave the business, the deal that you are likely to secure will probably leave you with a lot less than if you had planned your departure in advance.

Apart from failing to plan your exit, the biggest mistake that business owners make is assuming that leaving the business will be easier than setting it up. As you will see from the rest of this booklet, this is not always so.

Chapter One

WHY, **WHEN** and **HOW** are you going to leave your business?

For the vast majority of business owners, the dream scenario of selecting a retirement date and relying on their superannuation from that date onwards is a fantasy. Without proper planning, this will not be possible.

Before any planning is initiated, the following questions should be considered:

- When do you think you will want to stop working? Will it be at a specific age or when your children have finally flown the nest? Or when you feel that you have made enough money to fulfil other dreams without having to work full time?
- What do the other owners / key individuals within the business want to do in the future? Their needs may dictate how you shape the business and you will often be surprised by the response from each party.
- What do you want to do in your retirement? Do you want to keep your hand in as a business consultant or buy yourself a villa in the sun and take up golf? You might prefer to take on a number of non-executive directorships, learn to play the guitar or sail around the world.
- How much income will you require to support your retirement plans?
- How will your retirement income be funded and will your current superannuation be sufficient?
- If a shortfall exists in your projected income, how much are you going to rely on the proceeds from a business sale to supplement your existing superannuation?
- Which exit plan will yield the best results both for you personally and for the business once you have left?
- Are you going to withdraw gradually so that someone else can be groomed to take your place or are you going to withdraw completely on a specific date?
- Are you likely to survive in good health until retirement age is reached?

45 per cent of business owners claim to want to retire early. However the owners of small businesses tend to work longer often because they gain personal satisfaction from running their own business. So although the owner may wish to exit from one business, they are likely to continue to involve themselves in other businesses or organisations well beyond the conventional retirement age.

As the business owner, you are the only person who can answer the above questions. The answers will form the basis of your exit planning strategy. However, you must also recognise that external factors beyond your control may well get in the way of realising your objectives. These include family members and any business partners. You therefore need to adopt a flexible approach so your plans can adapt to the aspirations of others, changing market conditions and personal circumstances.

You only exit a business once. Your chances of achieving a good deal will be considerably enhanced by using a good team of advisers. These advisers can help you understand the marketplace and the real value of your business, and help to negotiate the best price.

What can professional advisers do for you?

Depending on the size and nature of your business and the internal resources you have available, an external adviser may be able to assist you with the following:

» Initial assessment of the internal operational processes within the business. This includes a review of the functional areas of the business, the external influences on the businesses, and your existing retirement arrangements.
» Vendor due diligence or "grooming" the business by assisting in "cleaning up" the core business of non-core or private elements. This will also include the early highlighting of "negative" aspects of the business that should be improved so as to avoid negatively impacting on value or the ability to execute the desired exit strategy.
» An indicative valuation based on the financial performance and the trends in the marketplace (including pricing indicators on similar business sales). This guide should provide an indication of what a buyer might be prepared to pay for the business. It should always be remembered that the price a vendor will get will depend on the buyer's perception of its worth to them.
» The development of a plan to market the business to potential buyers. This may involve approaching a restricted number or a wider audience of potential buyers. How many potential buyers are approached will often depend on the vendor's desire to maintain confidentiality.
» The production of an information memorandum to present a balanced view of the business while highlighting its key attractions to prospective buyers.
» Identifying and contacting prospective buyers using a combination of your knowledge of the marketplace and their own knowledge, experience and contact networks. The key is to identify which buyers would have most to gain from the acquisition and hence be prepared to pay the maximum price.
» Handling negotiations between you and prospective buyers to ensure that you get the best possible price for your business. Also, importantly, working with you and other advisers as a team.
» Minimising your tax liabilities through an understanding of your needs and the use of appropriate tax planning.

PKF top tips for selecting advisers

1. Ask your bank manager, accountant or business colleagues to recommend corporate finance specialists with the appropriate expertise for your type and size of business.

2. Try to find advisers who are the right size for your deal. There is no point in hiring people who specialise in selling $20 million IT companies if yours is a $2 million automotive component business.

3. Invite two or three firms to pitch for your business. Ask them who they have advised and ensure that they have the right contacts in your sector.

4. Only hire them if you think you can work with them. You need to feel comfortable with the individual(s) as you will be working closely with them for a considerable period of time and during the process there will be some difficult decisions to be made.

5. Make sure that you are speaking the same language. If the prospective advisers cannot communicate clearly with you so that you fully understand the process, do not hire them.

6. When hiring legal advisers, ensure they are used to doing corporate transactions. It is generally best to go for a good sized practice which has the in-house expertise to cover the various legal aspects of the deal such as property and employment. A larger practice will also have larger teams which should ensure they can deliver the legal support in a reasonable timeframe, which is important in getting the deal done.

Chapter Two

Developing the **Exit Plan**

Once you have identified your personal objectives and the likely timeframe for an exit, you should also think about the external factors that will influence your strategy.

For example:

» What is happening in the marketplace in which your business operates? Is it growing, shrinking, consolidating or fragmenting?
» Where are your products and services in their own lifecycle? For example, if you manufacture portable CD players, you may have already left it too late to exit.
» What are your competitors doing?
» Will you be able to stay ahead of technological developments in your industry by investing in research and development?
» Is there any legislation on the horizon that could have a detrimental impact on your business e.g. engine CO_2 emissions?

As well as considering the external influences on the business, you should also evaluate the internal workings. Here are some key internal points to consider:

» Is the existing management capable of operating the business without you, and do they have the expertise to take the business forward?
» Are the existing resources of the business adequate to meet future growth in the short and medium term?
» Do the operational controls and financial reporting systems provide timely and accurate data on the performance of the business?
» Are there any parts of the existing business that should be separated and treated differently?

Once you have completed your assessment of the business you should be in a position to decide on the most appropriate exit strategy. Remember that although you may progress down a particular route you should always remain open to other possibilities throughout the exit process.

The following options are covered in this booklet:

» Trade sale;
» Keeping it in the family;

» MBOs, MBIs and BIMBOs;
» Flotation;
» Winding up; and
» Innovative solutions.

Even though there is no specific need to document an exit plan, it is desirable to have it documented so that it may be revisited on a regular basis as things may change.

Be prepared to take decisive action quickly. For example, if there are signs on the horizon that your market is going flat, an early exit may be appropriate. Timing is everything as statistics show that the best time to sell your business is when it is still on its way up. This leaves the new owner with good growth prospects.

From a commercial perspective, the best time to sell your business may arrive before you had planned to exit. You will therefore need to weigh up the pros and cons of selling at this time, even though it does not suit your personal objectives.

Tax implications to consider

Even if your exit plan has a long lead time, you should consider the tax implications early. Some basic advice is:

» If you intend to sell to your management team, consider giving them tax-efficient share options in good time to motivate them and give them a stake in the business.
» If you intend to sell the shares in a company, review the balance sheet and activities of the company sooner rather than later. As far as possible, remove any non-trading items at least 12 months before sale.
» Seek early tax advice on whether you will be eligible for the small business capital gains tax (CGT) concessions. In some cases, proactive planning can improve access to these valuable tax concessions.

Always refer back to your exit plan when making investment decisions. You may want to retain any property used by the business after the sale or do not think that a prospective purchaser will value it. If so, consider separating it from the business at an early stage.

Chapter Three

Valuing your business and grooming it to boost value

Remember that your business is worth only what the highest bidder will pay. This is a common difficulty when selling a business. Your view of what it is worth may be very different from that of a prospective buyer.

Timing is key. Age, illness, family pressure or business problems often dictate timing. However the best time to exit will be driven by the financial climate, buyer activity and market trends. Issues such as heavy dependence on one person, product or customer may make it difficult, if not impossible, to sell.

The price a buyer will pay for a business will only be based on historical accounting information to the extent that it supports its future earnings. Instead, it is strongly influenced by the current profitability, expected future earnings and the risks involved in achieving those earnings.

When valuing your business, the following areas should be considered:

» The business history and its future prospects.
» Forecast cash flow, turnover, efficiency, costs and profitability.
» The performance of similar types of business in your sector (i.e. benchmarking).
» The asset backing of the business.
» The strengths, weaknesses, opportunities and threats of the business and the impact of these on the risk to future earnings.
» Recent deals in your sector to see what pricing indicators there are, such as profit or turnover multiples.

Your corporate finance adviser should be able to give you a range of possible values for your business based on the above. You can then benchmark these against any offers received and your own perception of the business worth.

Generally buyers will find businesses with good prospects attractive and hence be prepared to pay a good price. However, this will be tempered by any perceived risks specific to the business and its market generally.

Buyers will often be looking at a number of “value drivers” to assess the value of an acquisition to them. An integral part of your exit plan should therefore be to focus on achieving a number of universal and industry-specific value drivers to ensure your business is in good shape prior to sale.

Universal value drivers

- » Strong management;
- » Good growth prospects;
- » Good performance;
- » Limited dependence on individual staff, customers or suppliers;
- » Quality staff, customers and suppliers;
- » Strong internal control;
- » Relevant and timely reporting systems; and
- » Good asset backing.

Industry-specific value drivers

- » Standing of product / services;
- » Stability of growth within the sector;
- » Business resources such as technical expertise and workforce skills;
- » Operational resources such as property / plant etc; and
- » Metrics such as stock turnover / debtor days.

The extent to which you may be able to groom your business will depend on how early you start. Generally, grooming is aimed at fine tuning as opposed to radical transformation. Some key points to consider are:

1. Develop the management team as far as possible so the business can operate on a day to day basis without you. This is a key issue with smaller businesses and requires trust and possibly some reorganisation of the team. Selling a business can take up a great deal of your time. Having the right team will ensure the business can function properly without you.
2. Make every effort to keep your key people, particularly if you are in the service sector. Buyers will be very interested in the staff assets of the business and their retention post-sale. Consider giving key staff share options or bonuses to incentivise and motivate them. Remember that individuals have different needs. Therefore try to choose the incentives that will be important to them, to keep them onside.
3. Consider the timing of major investments in new product development, systems or property. The impact of these may not be visible immediately and consequently the value of these enhancements may not be reflected in the buyer's offer.
4. Remove non-core or less profitable assets or business operations and address and remedy identified weaknesses that may cause issues or delays during due diligence.

In addition to these essential strategies, other grooming activities may include:

- » Restating historic performance to show real performance of the business by removing non-recurring items. It is also important to highlight the star performing elements of the business as these may be masked in the normal financial reporting.
- » Identifying synergistic savings in the information memorandum so the buyer is clear on what could be achieved by combining the businesses.
- » Reducing risk of customer / supplier dependence as far as possible (heavy dependence may take some time to manage out).
- » Ensuring that your information systems are up-to-date and transparent. This enables a potential buyer to feel confident that reported results are dependable and they can use these to control the business post-sale.
- » Formalising contracts with key staff, customers and suppliers.
- » Reviewing employee entitlements to ensure the extent of any liabilities is fully understood.
- » Ensuring all legal agreements and documents are up to date. This may include property title documents, leases, licenses, share certificates and other statutory records.
- » Ensuring any actions against the business both externally and internally are at a point where the outcome is reasonably certain and the issues leading to these have been resolved as far as possible.

Regardless of your preferred exit option, your business should now present an attractive proposition.

Tax implications to consider

Remember that the value to you will be the after-tax sales value. Capital gains arising to individuals and trusts receive the general 50 per cent CGT discount. More importantly, capital gains arising from the sale of a small business may be eligible for a substantial reduction in tax under the small business CGT concessions. Taxpayers may be eligible for the small business CGT concessions where they satisfy the following basic conditions:

- » The $6 million maximum net asset value test or the alternative $2 million turnover test.
- » The active asset test – meaning that the asset being sold must be used in an active small business.
- » The significant individual test – meaning that the taxpayer must hold at least a 20 per cent interest in the business.

Where the taxpayer has satisfied the above three tests, they may have access to the following four concessions. Note that additional eligibility requirements apply to some of the individual concessions:

- » The 15 year exemption, which applies where the asset has been continually owned for 15 years, the owner is at least 55 and the business is being sold in connection with the taxpayer's retirement.
- » The 50 per cent active asset reduction.
- » The retirement exemption.
- » The small business rollover.

The small business CGT concessions have a slightly different application depending on how the sale is structured and whether the business is held as a sole trader, partnership, trust or company. Complex grouping rules also apply where multiple entities are involved. You will need to seek tax advice as to the application of the concessions to your business.

The sale of a business often involves a range of other tax issues. These can include the tax implications of repaying or forgiving loans, distribution of retained profits and ordinary revenue gains arising from the sale of trading stock and plant and equipment. Funds obtained from the sale of a business may also be used as an opportunity to make extra contributions into superannuation. This is a particularly tax effective option for those approaching retirement age.

Chapter Four

Exit route 1: The trade sale

Selling a business is a specialist area. Considerable skill, time and effort is required to achieve a successful outcome. Even with the right professional help, there is no such thing as a guaranteed sale.

Many business sales take between six months and two years to find the right buyer, and some never sell at all. For the best chance of achieving a sale at the right price, we recommend that you allow a timeframe of two years.

If you have decided on the trade sale route and have completed the grooming exercise you are ready to start marketing the business for sale. Together with your professional advisers, you should develop a business marketing plan that will include the following steps:

- Research potential buyers. This could include competitors, suppliers or existing customers as well as possible new entrants into your market. Normally you would look to approach a limited number of favoured buyers (say 30). For reasons of confidentiality you may restrict this to as little as five or six.
- Instruct your legal adviser to draw up a confidentiality agreement for interested buyers to sign.
- Prepare an information memorandum for your business. This should provide a balanced view of the present position and prospects while highlighting the key benefits to prospective buyers. Where significant growth is anticipated some conservative projections should also be included. Any preferences for the method of sale, e.g. shares as opposed to assets, should be mentioned in this document.
- Send out a brief anonymous profile based on the information memorandum to buyers with the confidentiality agreement.
- Issue the information memorandum to those parties who have signed the confidentiality agreement inviting initial offers to be made.

Always remember that the way information is supplied is fundamental to managing the buyer's perceptions of the business and you as the vendor. Buyers will not expect to be provided with everything, but key facts that may affect their investment should be released at an appropriate time. Although there is no fixed rule on timing, a buyer is likely to take a dim view of the release of some significant information on a problem late in the negotiations.

Once the initial offers are received you can start to narrow down the prospective buyers. Release of further information and meetings should allow you to select a preferred bidder. This party will normally be given

exclusivity to complete its investigations and agree the legal documents for the sale of the business.

Great care should be taken on the release of information, as the legal agreement will contain provisions to deal with problems relating to information which may reduce what you are paid for the business, and may lead to legal action against you. Therefore it is vital to have competent legal advisers as they will be able to guide you on what and how certain information should be disclosed.

Here are some guidelines to ensure that you get the best deal for a trade sale:

- Remember the indicative offer is just a starting point for discussion, as release of further information or changes in the buyer's position may alter it.
- Maintain competition as long as possible before granting exclusivity and use a timetable to keep the process on track. If buyers know others are in the frame they will pay more to secure the opportunity.
- Be sure that buyers can support their offers and what they need to do to deliver them. For example, a company with a bid backed with cash reserves may be more deliverable that a higher bid that is dependent on fund raising.
- Be sure to document the key features of an agreed deal including timetable (heads of agreement) in the exclusivity document. Include a provision to withdraw if the buyer reduces the price or fails to meet key milestones within the agreed timetable.
- Exercise reasonable caution with the release of sensitive information and consider holding back information on customers or supplies until close to completion.
- Remember that information flow is a strong tool for influencing the buyer. By slightly under-promising and over-delivering, and maintaining an open approach, you will gain trust which will help the deal progress more quickly.
- Consider drafting the sale and purchase agreement. Although this may result in more upfront costs, you are likely to maintain more control of the document. Furthermore it may speed the process up, provided it is not too vendor-biased.

Selling the business versus selling the legal entity

A key aspect of selling a business is determining exactly what is being sold. The two most common options are selling the business and selling your interest in the entity that owns the business (such as selling shares in a company or units in a unit trust). As such, it is important to understand the implications of the different valuation methods and jargon applied to each (i.e. enterprise value versus equity value).

Selling the assets will usually result in a different tax outcome to selling your interest in the entity. Prospective purchasers of the business will also have their preferences in terms of how they would like the deal structured.

We recommend you take adequate advice before accepting such an offer so that you have a clear understanding not only of the 'headline' sale figure, but also of effective after-tax sale proceeds.

Tax implications to consider

Sale of shares

A trade sale of the shares in your company will be a CGT event. You will need to consider whether you are entitled to the small business CGT concessions on the gain. Details of the qualifying conditions can be found in the preceding chapter.

The offer for your shares may not be in cash. The purchaser may want you to take some of its shares. This will require a valuation of the shares being offered as payment. However, you may be able to roll your gain into the new shares under the scrip for scrip rollover relief. If you are not eligible for the small business CGT concessions, applying the scrip for scrip rollover provisions is advantageous as it provides a tax deferral until you dispose of the new shares. However if you are eligible for the small business CGT concessions, it is often worthwhile by-passing the scrip for scrip rollover relief. This is because applying the concessions may have already substantially reduced the tax payable.

Many purchasers will want to tie in the key management team afterwards to ensure that the forecast results are achieved. This is particularly the case where agreement cannot be reached on an appropriate price based on forecast earnings. Care needs to be taken with earn-outs to ensure that you know whether these will be taxed as part of your capital gain on disposal of shares or in your capacity as an employee of the new owner.

Sale of trade and assets

The tax implications of selling the assets of a business vary considerably depending upon the type of legal entity from which the business is being operated (such as a sole trader, partnership, discretionary trust, unit trust or company). In general there are two levels of tax to consider:

- The tax implications of selling the business from the entity.
- The tax implications of distributing the proceeds from the entity to the ultimate owners.

The equation becomes more complex when there are multiple entities involved. A common structure is where the business is conducted from one entity, with the property from which the business is conducted being held in a separate entity.

It should also be noted that the sale of different categories of asset have different tax implications. Common types of assets in a business sale include goodwill, plant and equipment, commercial property, trade debtors and inventory. The proceeds from the business sale will need to be apportioned over each category of assets, with the tax treatment of each category being dealt with separately. There may also be an opportunity to make additional contributions into superannuation over this period, which may reduce the tax payable.

Chapter Five

Exit route 2: Keeping it in the family

When a small business is a key component of family wealth, the owner often has a strong desire to perpetuate it in one form or another. Achieving this through an orderly succession to family members or other insiders is the ultimate management challenge. It involves the consideration of a whole range of business, family, tax and estate planning issues.

Any transition must preserve the continuity of leadership and it is particularly important that the succession of ownership and management be perceived as a process rather than an event.

For the best chance of success, the process requires planning, teamwork and constant re-evaluation. Worryingly, statistics suggest that less than 25 per cent of family businesses survive into the next generation and fewer than 15 per cent of them endure into the third.

A typical succession plan has two elements, which should be considered separately:

1. The transfer of power – whereby control over the business's operation is transferred to those best suited to exercising it.

2. The transfer of assets – whereby the wealth concentrated in the business is transferred to designated family members. This may be a different or larger group than the person or persons who will be assuming power.

Handing over control to a relative is the most popular choice for family businesses. Many who opt for this route feel happy they are leaving the business in safe hands and confident they will be able to continue to play a part in running it.

However, great care should be taken when selecting a successor. Succession decisions are often made on emotional grounds or to avoid family arguments rather than for sound business reasons. Although tradition may suggest that the obvious person to take over is the eldest son, he may not necessarily be the best choice. It may also be tempting to put different children in charge of different parts of the business to demonstrate equal treatment, but this is likely to result in leadership battles.

The following points may be useful in developing a handover strategy.

» Be objective when analysing the strengths and weaknesses of potential successors. Ask yourself questions such as:
  - Are they committed to running the business?
  - Do they possess the correct leadership and management skills?
  - Are they capable of taking the business forward?
  - Is there someone else within the family more qualified and interested in running the business?
» Assess the benefits of appointing external management who are impartial and outside the family ownership circle.
» Consider regular strategic planning meetings that include key employees as well as family members, to help you assess performance.
» Conduct all discussions with your family about the succession at work rather than at home. Document the decisions and actions taken so that there can be no arguments at a later date.
» Select and regularly communicate with a team of outside advisers. This should include lawyers and accountants, who have experience with closely held businesses, funding requirements, other complex corporate matters and estate planning.

Once the choice has been made, the potential successor(s) should be fully prepared for their new role through formal training and mentoring. Look to involve them in different areas of the business so that they fully understand how it operates.

The business entity may have been used to “store” family money as well as that earned through the operation of the business. The successor may wish to separate out the family assets and distribute them to siblings before taking on the running of the business. However, the business should retain sufficient reserves to function properly. Tax considerations will also need to be addressed before making any asset disposals.

Tax implications to consider

No business succession occurs until the current owners perceive themselves to be financially secure. Tax advantaged tools such as superannuation contributions and utilising the small business CGT concessions are likely to be valuable components of ensuring the financial viability of the current owners.

In a family business succession it is common for at least some assets to be transferred to family members for either nil or below market value. Whilst this may be a “cashless” transaction from a family perspective, the sale of any CGT asset is deemed to take place at market value. Therefore a family transaction in which no cash changes hands can result in a substantial CGT liability.

Proactive tax planning helps to alleviate this problem, considering factors such as whether there are any pre-CGT assets involved or using the small business CGT concessions. Where farmland is involved, stamp duty concessions exist in some states for the transfer of the land to the next generation within the family.

The new generation of family business owners should also consider the most effective structure to acquire and operate the business moving forward. Considerations should include a structure that offers tax effective access to regular income flows from the business, the deductibility of any interest costs on any money borrowed to acquire the business and a structure that offers a tax effective exit upon the eventual sale of the business.

Chapter Six

Exit route 3: MBOS, MBIS and BIMBOS

The three exit options of Management Buy-out (MBO), Management Buy-in (MBI) and Buy-in Management Buy-out (BIMBO) have the potential to release the owner from the business relatively quickly and easily.

These options do not involve the commercial risks arising when other business owners review your business. However the price you are likely to get may be less than that offered by a trade buyer who can afford to pay more as a result of synergy savings. That said, occasionally some strong management teams that are backed by private equity may be able to match a trade price and sometimes even exceed it.

The principle for all three options is that the business is purchased by a management team – either the existing team (MBO), a new external team (MBI), or a combination of the two (BIMBO).

The success of the transaction is largely down to the calibre of the management team involved. There is little point pursuing this route if you do not have confidence in the team's abilities.

Management Buy-out

A MBO is the purchase of a company by the management team that already runs the business. This option is particularly useful for family firms looking to overcome succession issues and offers the following benefits:

- The handover of the business is often completed quickly as the buyers already have a good knowledge of the company.
- It allows you to feel confident in the knowledge that your business is being run by trusted and committed people.
- You can leave your business in an amicable way and be seen to be safeguarding the interests of the employees.
- It allows you to quickly realise value for the business you have created.

However, there are disadvantages, the most common of which are:

- It is rare that there is a natural leader in the management team.
- The management team will need to raise money to buy the business.

- Pricing is often an issue, especially where trade offers are significantly more than the management's offer.
- Deal structures will often require some deferred consideration to help fund the transaction which may be at risk if the business fails.

Businesses suitable for a MBO generally have the following characteristics:

- A balanced and experienced second-tier management team;
- A strong track record of profitability;
- Good growth potential;
- Good positive cash flow;
- Relatively low debt levels;
- Not involved in businesses with a significant requirement for capital equipment;
- Good quality products / services with a competitive advantage or unique selling proposition;
- Not reliant on a single product / service or a small number of key customers or suppliers; and
- Good relationships with customers and suppliers.

Most MBOs involve high levels of both debt and equity finance. This high gearing will expose the business to risk in the event that something does not go to plan. Sufficient headroom should therefore be available in the funding package and debt repayment profile to cater for some slippage on planned performance. Equity finance will make most of its return on the sale of the business and typically this will be achieved within five to seven years.

Management Buy-in

A MBI is similar to a MBO, only it is an external management team that acquires the interest. This typically happens when a business is under-performing and requires a more experienced or differently skilled management team to take it to the next growth phase.

A MBI requires similar financial backing to that required by a MBO but, not surprisingly, many institutions view them as more risky as the incoming management is deemed to have less knowledge of the business.

Many venture capital firms now have teams that are willing to buy into existing companies. When looking for potential investors, they carry out detailed and formal assessments of each candidate to ensure that they have a proven track record in the same industry or sector as your business.

A company suitable for an MBI should display the same characteristics as those for a MBO, but MBIs may also have the following disadvantages:

- The new management team will be less familiar with the internal workings of your business.
- Conflict may be created with existing staff who may feel suspicious of "outsiders" coming in and taking over the business.
- As they are viewed as riskier than MBOs, the price the team can afford with funding will generally be less than that offered by a MBO team.

The initial requirement when considering either of these options is to work with your adviser to prepare an appraisal of the management team to assess whether or not they are "bankable", along with an analysis of the business to ensure that it meets the characteristics listed above.

Your advisers should provide a rough estimate of what price could be achieved using a MBO structure. You may then allow the team sufficient time to secure funding offers and to confirm the structure of the deal.

As with a trade sale, the team will want an exclusivity period to complete the transaction, so before this is granted you will need to agree a timetable and key elements of the deal.

The legal agreement in connection with the sale may be less onerous for MBOs / BIMBOs as the management will be deemed to have knowledge of the business.

Buy-in Management Buy-out

This option is a hybrid of a MBO and MBI and combines the knowledge of the existing team with the additional expertise of a person from outside the business with strong management and leadership skills.

A BIMBO is usually the preferred option for businesses where the profile, leadership qualities or management style of the exiting owner will be sorely missed by the existing team and a substitute will be required to ensure success.

If, however, the existing team has been used to running the business and the owner has already handed much of the day to day running and decision-making to them, a MBO will probably be more appropriate.

Tax implications to consider

The tax implications for the vendor are usually relatively straightforward in a MBO, MBI or BIMBO because the shareholder is making a clean exit. The tax issues arising are similar to those identified in chapter four.

If you are aware that your likely exit will be a sale to the management team (a MBO), you may wish to motivate them by issuing tax-efficient options, such as through an Employee Share Acquisition Scheme, over the shares in the years leading up to your exit.

PKF top tips

We recommend that every individual involved in a buy-out / buy-in should take independent financial and legal advice before proceeding, as there are likely to be some cost commitments from an early stage.

You need to consider what you will do if the team fails to meet the price expectation. Generally both sides should agree that there is a period to explore the scenarios, and that if it does not work out they can return to work. Clearly the experience will divert management's attention from the business, so it is important that this issue is considered. It is probably best to avoid any talk of a MBO / MBI if you and your advisers feel that the offer is not close to your price expectation.

Chapter Seven

Exit route 4: Flotation

Going public is often referred to as an exit route. But the reality is that flotation is not an exit in itself, only a means to achieve its longer-term strategic objectives.

Owners often find themselves even further from being able to exit their business after a public sale than they were before. However, as a flotation can provide a means to achieve a total exit over time, we have included it in this booklet.

PKF usually advises that a flotation may be an appropriate exit route for investors (e.g. private equity). However it is not usually the best route for an owner or majority shareholder.

Going public may be achieved by way of an initial public offering (IPO) or by way of having the company or business acquired by an already listed company in which the vendors will now become the significant (or maybe even the majority) shareholders. This latter mechanism is often referred to as a "back-door listing".

An IPO is also only really an option if the business is sufficiently large. This is because a great deal is required to make the most of this opportunity and the advisory costs can be too high for a small business to bear. A "back-door listing" may be appropriate in the case of small businesses, especially when the business can add value to the already listed company.

In very broad outline, the main benefits and drawbacks of floating a business are listed below:

The benefits of flotation

» Access to capital
As a public company it will be able to raise finance at the time of flotation and have greater access to capital in the future for future growth.

» Cash out
Flotation may provide an opportunity for existing shareholders to realise part of their investment.

» A market for the company's shares
Floating your company creates a public market in which shares are readily tradable. This may be used to incentivise management and key staff by way of option or share schemes. If the company performs well both you and the other employees will benefit from the improved share price. It should be noted that, generally, shares that are readily tradable on an organised exchange are more highly valued than shares where sale or transfer is restricted or cannot be undertaken relatively immediately.

» A higher public profile
During and after the float, your company will be very much in the public eye. The publicity will help to raise awareness of your company and its products (and possibly increase its value).

» Reassurance for customers and suppliers
A listed company is regarded as having a higher financial standing. This, together with the regulatory and due diligence checks necessary to come to market, may reassure both customers and suppliers.

The drawbacks of flotation

» The expense
The overall costs of flotation, raising additional capital and the ongoing costs of maintaining a listing may outweigh the benefits, particularly if your business is relatively small.

» Investment of time
Floating a company takes up a substantial amount of senior management time. It is all too easy to neglect the company that you are trying to float. You should also be aware that post-flotation time commitments are high – for example, to maintain investor relations.

» Loss of privacy
Your company will find itself increasingly in the spotlight. As a public company you will be required to make detailed stock market disclosures. The expectations of the market and public shareholders may also result in limiting the decisions that the company can make without adverse impact on its share price.

» Bull and bear markets
The state of the economy and the stock market are outside your control. Yet these may have a significant effect on the price you can achieve at flotation and when you want to sell your remaining shares.

» Take-over risk
Your company may be subject to a take-over which may result in management and staff being removed by the new owners. In contrast, you may have been able to protect them under another sale mechanism.

As you can see, the flotation route is more appropriate for an owner who is seeking the next major stage of growth rather than one who is trying to leave.

Finally, it is worth bearing in mind that a flotation is rarely the route to riches that so many believe it to be. Even Sir Richard Branson took Virgin back into private ownership as flotation made him realise how much shareholder pressure to perform was constricting his day-to-day running of the company.

In addition to the drawbacks outlined above, a flotation does not represent a clean break from management. You may finalise your deal at the peak but, by the time you sell your last share, the share price could have dropped considerably, particularly if there is a new management team running the company who may not have found their feet yet. If you are still running the company, you not only have a continued financial exposure but you will still have the stresses and strains of being in the spotlight that constantly shines on public companies.

Chapter Eight

Exit route 5: Winding up a solvent company

There are a number of reasons why a company owner would consider a members' voluntary liquidation (MVL) as an exit route for a solvent company rather than any of the options already outlined.

It may be necessary to liquidate a family company if there is no second generation to take over the management of the business when the current management retires. If the company has suffered losses with no prospect of a return to profitability, the owner may often decide to close the business before it becomes insolvent to enable a return of capital to be made to shareholders.

How does a MVL work?

To wind-up a solvent company, the directors have to make a written "solvency declaration" stating that the company will be able to pay all creditors in full within 12 months. The shareholders of the company must pass a special resolution to proceed with the members' voluntary liquidation. This resolution must be passed by at least 75 per cent of eligible members who vote at the meeting.

The winding up commences at the passing of the special resolution. The advantages of a MVL resolution are that the members can choose the liquidator to take control of the affairs of the company, fix the remuneration of the liquidator and, in general terms, supervise their conduct.

PKF top tip

You may have decided that the business is going to come to an end when you retire. When the time comes you need to ensure that all the monies owed to you are collected and that you realise the value of all your business assets. These funds could be an important part of your retirement fund. Again, you will need to arrange this properly to minimise your tax liabilities and maximise your income in retirement.

When considering a MVL, these are some of the issues to consider:

» Professional adviser – a MVL has to be dealt with by a licensed insolvency practitioner.
» Risk management – proceeding too quickly without adequate investigation and planning could leave both you and your advisers open to criticism and claims.
» Taxation – pre-liquidation tax planning is essential to minimise the tax costs or to resolve the competing tax requirements of those involved.
» Proper enquiry – you and your advisers need to ensure that proper enquiries are made and the statement of assets and liabilities reflects all actual and contingent liabilities of the company. Particular attention needs to be paid to:
  - Taxation liabilities.
  - Liabilities relating to property and particularly any old property leases which may have been assigned but where the lease term has not yet expired.
  - Employee entitlements.
  - Guarantees given by the company, e.g. in respect of group banking obligations, or warranties in respect of goods or services supplied.

Tax implications to consider

The tax implications of a MVL need to be considered at both the company and shareholder levels.

Like any other creditor, debts with the Australian Taxation Office (ATO) must be discharged as part of the liquidation process. This means lodging a final income tax return and obtaining clearance from the ATO that there are no outstanding tax liabilities. The range of tax issues arising at a company level during the liquidation process include:

» The CGT implications on the sale or in specie distribution of assets.
» Tax rules related to commercial debt forgiveness or loans to private company shareholders.
» There may be stamp duty and GST consequences arising from the liquidation.
» Specific tax implications arise where the company being liquidated is a member of a consolidated group.

The tax implications of liquidators' distributions depend upon the underlying nature of the funds being distributed (i.e. revenue or capital) and the status of the shares (pre- or post-CGT). Key pieces of information in determining the CGT implications at a shareholder level include:

» Pre-CGT shares (which are likely to be exempt from CGT unless the company has post-CGT assets exceeding a specified threshold).
» Capital proceeds for the cancellation of shares (which consists of the full amount of liquidation distributions, including the market value of assets distributed in specie).
» The timing of interim distributions.
» Possible application of the general 50per cent CGT discount and the small business CGT concessions.

Chapter Nine

Exit route 6: Innovative solutions

There are two other options that you may want to consider: a partial exit, or a joint venture with an overseas company that wants to enter the Australian marketplace.

Partial exit

A partial exit is an option if you have a strong business that is attractive to investment groups or venture capitalists (VCs). This option can be useful if you want to release some cash now but stay in the business until it has reached the next level of growth and profitability. It could be called the 'some cake now but plenty more later' approach to exiting a business.

VCs are increasingly happy to look at the partial exit option which is effectively a MBO where the owner stays on as part of the management team. For example, if your business is worth $10 million, you could raise $4 million for yourself by releasing 40 per cent of the equity to a VC. They will put a non-executive director into the company to work with you to grow the business further and prepare it for a subsequent sale.

The drawback of this route is that you have to keep working in the business but you will have a lump sum available to play with and the prospect of a greater return on the eventual sale.

Private equity is focused on making high returns, so if VCs do get involved it is because they see the potential for this. However, their investment documentation may give them some significant control mechanisms if things do not go well. You may lose control and have your shareholding diluted to the extent that, on sale, you get much less than you would have received if you had sold out at the time they invested.

International entrant

The second option is to find an overseas company that is looking to enter the Australian market through a joint venture and / or to buy an option in a business. From the overseas entrant's perspective, this option offers a low risk entry into the Australian marketplace for sales and distribution of their products and services.

If the initial joint venture is successful, the overseas company may buy your business.

This sounds like a win / win option for both you and the overseas entrant. However it requires considerable investigation to identify and attract the right joint venture partner, as well as plenty of luck with timing.

You should consider carefully what each party will bring to the joint venture. Issues include how the venture will be managed, how the respective commercial confidentiality of both parties will be maintained and how it will be dissolved (either if things do not work out or after an agreed period). You will require advice from a lawyer with experience of international contracts and corporate finance advice on the structure of the entity.

Tax implications to consider

These solutions generally involve a partial sale from a tax perspective. There may be more complex structuring involved depending on the investor and the documentation but it is likely that any sale of shares will trigger a capital gain for the shareholder.

Some of the international joint venture options may not involve disposals at all. In this case, you should take tax advice to ensure that there will be an equitable distribution of after-tax returns from the joint venture for you and your prospective partner.

Chapter Ten

Business and family wealth preservation planning

Making a controlled exit from a business should result in a planned and seamless transformation into the new life that you wish to lead. Adequate planning will ensure that an acceptable lifestyle can be maintained, with protection of your capital wealth and income built into the transition.

Together you should consider the following planning issues:

- » Review of your existing superannuation arrangements:
- » Investment portfolio management;
- » Estate planning; and
- » Asset protection.

Existing superannuation arrangements

What is your current situation? Are you paying the right amount of contributions into the right superannuation fund for you?

Funding significant superannuation contributions from your business can be one of the most cost-efficient ways to plan for your retirement. Superannuation contributions for employees and self employed persons are, subject to certain limits, tax deductible to the business and subject to a 15 per cent contributions tax in the fund. In addition, individuals may make non-concessional (i.e. non-tax deductible) contributions to the fund, once again within prescribed limits.

Earnings within a superannuation fund are taxed at a rate of 15 per cent, reducing to 0 per cent on assets segregated for members in pension phase. The fund is entitled to claim full dividend imputation credits and receive a 33.3% discount on capital gains. Altogether this makes a very tax effective package for providing for an individual's retirement.

Although large superannuation contributions can be tax-efficient, they will, of course, drain cash from your business. Many business owners contribute only the minimum mandated amounts into superannuation in the early years of the business. Contributions are increased as profits increase as the business matures. There may also be an opportunity to make additional superannuation contributions at the time of selling the business, such as under the retirement exemption within the small business CGT concessions.

For more information on any succession management issues or other services offered by PKF, please contact your local adviser on: 1300 753 222

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