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"Destroy Shareholder Value in 6 Easy Ways"

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Introduction

Businesses don't have a set value, only a value to somebody else. This can change rapidly as it is ultimately based on external factors; for example GO was bought for £110m in June 2001 and sold again in less than year for £374m.

There is no effective proxy for shareholder value. Shareholder value is hard to estimate in private companies. Not only is it not managed (difficult without measurement), it is often never discussed. This leads to a lack of appreciation of its importance and often to decisions that result in destruction of shareholder value.

Many private companies model their Boards on those of quoted companies, which are designed principally to address an issue not present in most private companies; the divergence of interest between managers and shareholders. Better models exist.

THE SIX EASY WAYS

● Never Talk About It

If Boards are not actively building share-holder value, then they are effectively destroying it. In people-based businesses ("PBBs") failure to align the interests of Board and shareholders may mean that this central issue cannot even be discussed.

● Don't Plan for the Exit

Buyers buy businesses because they fit into their strategy. Companies should ensure they are a good fit for a number of buyers, thus creating the conditions for a competitive bidding process when they come to sell. Diversifying a business can be the surest way to reduce demand and consequently destroy shareholder value.

● Wait Until the Last Moment

Vendors who defer selling too long risk being unable to attract new talent (the life blood of any people based business), and severely restrict their own options. Many believe that, by so doing, they will safeguard the culture of the business they have built, when actually they are laying the groundwork for its destruction.

● An MBO: No Easy Answer

MBOs seem to provide an easy exit. In reality, they often mean that the interests of the principal shareholder are diametrically opposed to those of the management team. Once an MBO has been embarked upon it is very hard to turn back, and the resultant value may be less than half of what might otherwise have been realised.

● Don't Appoint an Advisor

Selling a business successfully is a difficult exercise. Vendors often attempt to do it by themselves or with advisers who do not know their sector. People based businesses are not like any other asset, the very knowledge that they are for sale can damage their value; and vendors' confidentiality may not be best protected by generalists advisers.

● Don't Plan the Future

The failure to plan life after the transaction is the most common reason for deals failing either to complete (with all the attendant costs) or to complete but fail to deliver the earn-out. Either outcome is unsatisfactory for vendor and staff alike.

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Which value?

What value Go? £110m or £374m?

3i bought Go for £110m in June 2001. Less than a year later, easyJet paid £374m for the same company.

People talk of the 'value of a business'. This is misleading shorthand for what is key: the value of a business to somebody else. Not looking at your business from this perspective can seriously damage your wealth. People buy businesses because they fit into their strategies, not because they make money.

An industry dedicated to buying companies that do not fit into anyone else's strategies has emerged: venture capitalists. They aim to buy cheap; they hold businesses until a strategic partner emerges (such as easyJet); or they seek to break the business up and to sell the parts to strategic buyers (HMSO / The Stationery Office was bought from the Government in 1996 and subsequently sold as four separate businesses). Businesses should learn from the VC approach to their own investments, to avoid becoming one.

Value destruction

At IMAS we regularly see the value in people-based businesses dissipated. Value destroyed during the life of a business may only become evident at sale. Existing shareholders of businesses can frequently realise around 30% less than would otherwise have been achievable from their stakes.

We have written 'Destroy Shareholder Value in Six Easy Ways' to show the reasons why this can happen, and to outline ways in which it can be addressed not just at point of sale but throughout the lifecycle of a business. While IMAS has extensive experience within the UK financial services sector, the principles examined here apply to all people-based businesses and, to a lesser extent, to many privately owned companies.

What are people-based businesses?

The broadest definition of a people-based business or 'PBB' would be one where the key assets leave the office and go home at the end of the working day.

Pure talent businesses (such as those focused on top sportsmen or a particular pop star) usually consist of little beyond the talent of individuals; the business has no real goodwill of its own.

At the other extreme are service businesses (such as Direct Line) where the key value is in the huge brand, impressive systems and low cost delivery; individual staff members could be replaced without impacting the business.

PBBs combine talent with service; both 'people' and 'business' are critical.

Economic versus legal ownership

All companies have stakeholders, but with PBBs the employees may become the business.

A powerful indicator of the extent to which this has happened to a business is how profits are allocated. If profits are used to pay not dividends but bonuses to key staff, then the value has, in part, already transferred from the legal owner to those employees. This split of economic and legal ownership will have important implications on exit, as the shareholder(s) will likely have to recognise this in the terms of any deal.

With most assets, the mere act of selling should not impact on their innate value. For example putting your house on the market and then withdrawing it, should not impact on its value long-term. Most property sales do not involve earn-outs, confidentiality agreements or restrictive covenants. Selling your PBB is very different.

Value models

Shareholder value effectively comprises two elements: income, and growth in the business's goodwill.

It is useful to compare the relative attention given to these elements by different types of business:

Privately-owned companies

- the focus is largely on gross income
- the business's capital value or goodwill is an unknown, only tested on sale
- as value can't be measured often no attempt is made to manage it

Quoted companies

- key measurement of the success of a quoted company is its share price
- the share price and 'value creation' are a matter of constant comment
- no director of a quoted company can afford to ignore this preoccupation

The workings of quoted companies' Boards are driven by the split of management and ownership. As this is not normally relevant for private companies, the mimicking of quoted company management style is at best inappropriate and at worst damaging.

It would be far more useful for private companies to replicate the discipline and robust questioning of strategy by outsiders that is supplied to quoted companies by analysts, journalists and institutional shareholders.

Venture capital companies

- focus on all aspects of potential return from their investments – capital and income
- are always planning for the exit: searching for acquisitions to enhance value; avoiding diversifications that might damage attractiveness on exit and incentivising management to optimise the total return to shareholders

The VC / private equity model is probably the best one for PBBs which want to maximise their shareholder value.

The six easy ways

In this paper we are not dealing with the operational issues of how to make your business more profitable, but instead set out six key factors that we believe most commonly contribute to the destruction of shareholder value in PBBs:

- Never Talk About It
- Don't Plan for the Exit
- Wait Until the Last Moment
- An MBO: No Easy Answer
- Don't Appoint an Advisor
- Don't Plan the Future

The conspiracy of silence

In theory, maximising value is the most important issue from the perspective of shareholders. And yet our experience at IMAS has been that many private companies rarely raise the issue in the boardroom, and certainly never outside it. This is especially true of PBBs if the legal and economic ownership are out of kilter.

If it is not measured, it is not managed

As it is seldom talked about, the great majority of Boards do not realise that they are not judging themselves by the single most important benchmark: shareholder value. Consequently, the principals of such businesses have limited understanding of the real drivers of their companies' value - and this leads to major errors of judgement.

Profits are a poor proxy for value

Many comfort themselves with the notion that the issue of shareholder value is tackled by discussing maximisation of profit. Profits are a very poor proxy for value as:

- buyers are driven by strategy
- profits attract widely differing valuations; in the quoted sector Price/Earnings ratios range from 6 to 24 and beyond
- diversification (see next section); potentially a key value destroyer, is ignored when measuring profitability

Aligning interests

There is a simple but powerful objective test: can the issue of shareholder value be discussed at Board meetings in an open and frank manner?

If the answer is no, what action should be taken to address this crucial structural fault? Incentives such as options or shareholdings will probably need to be in place on exit; if so, there is a strong argument for their early introduction.

How attractive are you?

Owners of private businesses might follow the example of private equity institutions who, before investing and throughout their ownership, keep focused on what buyers in general are looking for; and what the most likely buyers will find attractive about their particular business.

Look before you leap

It is important to understand a business's key attractions to potential buyers. For example, 'brand' as a saleable asset in PBBs seldom repays the amount of effort put into building it, as most buyers will wish to integrate and rebrand the acquired business within their own.

It may be helpful to analyse your business regularly by such key categories as skills / markets / location / distribution / management. You will then be able to judge whether proposed corporate developments – from acquisitions or restructuring, to diversification – would be most likely to:

- increase or decrease your company's attractiveness to potential buyers;
- limit or widen the number of buyers who would be interested in you.

The desire to diversify

Even though investing institutions are well equipped to achieve diversification themselves by appropriate portfolio selection, Boards of quoted companies often seek to diversify as a way of smoothing earnings and potentially making themselves less attractive takeover candidates.

Heads of private companies, as they get older, become risk averse as their wealth becomes concentrated in a single growing asset and they see their effective working life shortening. Their desire to diversify is enthusiastically supported by the next tier of management who anticipate greater job security based on smoothed earnings and the increased need for their skills in a more complex corporate structure. A raft of advisors and lawyers will also be delighted to assist in this process!

The impact of diversification

The most common result of diversification, unfortunately, is to reduce the value of a business both during the period of ownership and on exit. 'Bolted-on' units often perform less well because they do not have critical mass and suffer from lack of management focus.

When it comes to a sale, diversification can have three significant negative impacts on the value attainable:

- the number of logical bidders may be drastically reduced
- having one committed buyer for the entire business which is a reasonable fit will not get you the highest price
- typically different bidders will only fully value the parts of the business in which they are interested.

Our experience at IMAS has been that in sealed bids for diversified companies, a wide range of prices are offered. In the case that (say) a top offer is around 10% higher than the next, a seller usually has very limited ability to push up this top offer. Where there are two bids at around the same price there is an opportunity to significantly improve the best offer.

The above factors may result in discounts on asset bundles unattractive to bidders of 30% or more, assuming a bidder can be found at all.

Resisting the short-term pressures

Given the pressure on Boards to diversify, it requires strength and clear thinking to resist such developments for your business.

The oldest swinger in town

IMAS often sells businesses for retiring shareholder/directors. All too often principals find that they have simply held on for too long.

Many in this position will have convinced themselves that it is not an issue. Some may find that judicious use of a toupee will reassure people that they are not planning to sell. In reality, such maturity issues will not go away.

A while ago IMAS had a meeting with two 60-something shareholders. We told them that their staff would regularly be discussing the question of succession behind their backs. While one shareholder categorically contradicted this, the other then conceded that on arriving late at the last Christmas Party this was the first question that he had been asked by a 'tanked-up' member of staff.

Impact on seller's alternatives

Waiting until the very last moment has a number of damaging effects on the value of a business, as the key to selling a business is always to have other options. Leaving a sale until too late dramatically reduces flexibility; for example, the seller's option to do nothing (i.e. not sell) is effectively ruled out.

Impact on business before sale

Ageing shareholders of PBBs impact the strength of a business even before a sale is contemplated.

It may become difficult to attract good senior staff (whose presence is key to a future buyer) as they will anticipate the sale of the business in just a few years and fear for their own positions.

Winning new customers, although they would never admit it, is harder as they can foresee a change of ownership.

Continuing influence on business

One objective of many selling shareholders is for their business's culture to be maintained after a sale. While this aim is laudable, they may find that having held on for too long it is actually self-defeating.

A buyer may be willing to accept that a 58-year old vendor will be involved for another five years. If, on the other hand, the vendor is 68, any buyer will assume that it will receive very limited ongoing support from them. The only type of buyer likely to consider it is, therefore, one that has all the existing skills needed to run the operation; not a buyer looking to enter the market. Such a buyer will want to integrate the operation into their own, thereby destroying the culture that the vendor was so keen to preserve.

Risk profile

By holding on until the last minute, you are taking a major gamble on:

- there being suitable buyers;
- the state of the market;
- your health;
- your next tier of management;

whereas this is exactly the time when you should be aiming to de-risk your major personal asset.

The 'Third Way'

Given the split of economic and legal ownership which exists in many PBBs, the existing management may, in theory, be a natural buyer for a business. An MBO is often seen as an obvious and very attractive way for vendors to guarantee that an exit is achieved, ensure that the existing culture is maintained and reward senior staff.

In practice, following this route can devastate shareholder value. In most cases an MBO team will start with a number of disadvantages compared to trade buyers in terms of its ability to pay anywhere close to full value:

- an MBO does not have the advantage of any cost savings - by definition there are no 'synergy' benefits;
- the management team may have limited resources of their own;
- the supporting venture capitalist is likely to be backing an untried team, or taking advantage of the absence of competitive bids

All of these factors will invariably reduce the amount an MBO team can pay.

Can't pay won't pay

The main reason why MBOs can so impact on shareholder value is the deadly combination of the management team's inability to pay top dollar and its de facto control of much of the business's goodwill.

There are a number of common scenarios why value can be so damaged:

When negotiating with a strong management team:

A key factor in a reasonable price being obtained in an MBO is the ability of the vendor to replace top management if necessary. In many companies, the manager who leads an unsuccessful MBO is required to leave and this has no material effect on the business.

But sack your heir apparent in a PBB and they will become a principal competitor, approaching your firm's key clients and saying that you plan to sell. How strong a position would that put you in?

When there is no existing senior manager:

There may also be problems when the vendor is actively involved in management himself, normally as MD. In such cases, there is often no clear successor in place but one is selected to lead the proposed MBO. This can result in disappointed candidates who might have been willing to accept anybody new as boss, but will not work for a colleague.

The danger is that they will take themselves and the business they control elsewhere and fracture a team which has been built up over many years.

No turning back:

It is in the interest of the MBO team to tell staff, suppliers and customers that an MBO is planned, and to imply that this is the only viable outcome in the sale process. This, in practice, commits the vendor and damages his negotiating position. Having embarked on an MBO route, the vendor becomes increasingly aware of the weakness of his position and lowers his asking price to bridge the gap, often only to find the price falling further.

Fools rush in

Lord Hanson used to say that he would "sell to anyone but the management" - and they made bricks. An MBO can result in your objectives and those of the team becoming diametrically opposed; this can devastate shareholder value.

MBOs can work, but normally take 5 to 10 years to build an equity position of the next tier down as platform for an appropriate offer. Embark on an MBO without this and the value of a PBB can be halved or worse.

DON'T APPOINT AN ADVISOR

(OR APPOINT THE WRONG ONE)

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A man who defends himself has a fool for a lawyer

A surprising number of shareholders attempt to sell their businesses without employing any advisor.

- they think that they already know the likely buyer(s);
- they are sure – a common belief at the start of most transactions – that theirs will be a very simple deal;
- they want to save money.

IMAS is frequently called in by vendors who have embarked on the selling process themselves and encountered problems. Much of the damage done cannot be rectified.

It is crucial to have an independent view of the important issues relevant to a sale - the business's relative strengths and weaknesses before it is presented to purchasers, for example.

PBBs are not soap powder

A more common error than appointing no advisor – but one that is just as destructive to shareholder value – is to appoint an advisor who does not know your sector.

The advantages of appointing a sector specialist are:

- An advisor who knows your field is best-placed to identify the most likely buyers, targeting only these and therefore maintaining confidentiality, as well as maximising competition;
- A specialist should already know some of the potential buyers well. They will understand the nature of their existing business, strategic direction and negotiating style, and will be able to advise on culture fit;
- Potential buyers wishing to buy in from outside the sector will have made their interests known to the high-profile industry specialist.

Strictly Confidential

Using a generalist advisor presents serious risks for your confidentiality. They compensate for their lack of knowledge by effectively ensuring the selling company's details are circulated as widely as possible, relying on a few signed sheets of paper to ensure confidentiality (which unfortunately they don't).

If everybody knows that your business is for sale (but not yet sold) it's perceived quality, and hence its value, drops. As purchasers know that everyone else knows, they will be unconcerned about late competition and more likely to put in a low offer. As a result, the vendor has limited room to manoeuvre and his negotiating position is greatly weakened.

You only sell once

The preparation and handling of a properly-conducted sale is always labour intensive. It can be hard for management to handle the process while also running the company. If business is consequently neglected, this can greatly affect the consideration achieved. Buyers pay extremely close attention to current trading during the latter stages of a sale.

As for cost, most advisors take the majority of their return in the form of success fees, based on gross proceeds of the sale. If no sale occurs, costs are contained. If the sale happens, an expert advisor will have been able to achieve a significantly higher price than the vendor would have and so the service is more than paid for by this uplift.

Vendors should use advisors to maximise the value of the 97%, not fuss about paying 3% at the end of a successful process.

It'll be alright on the night

If there is one single reason why deals fail before completion, or go wrong afterwards, it is that the two parties have failed to undertake the necessary detailed discussion and planning as to how their businesses are to be combined.

Experience shows, counter-intuitively, that change is better accepted if carried out rapidly. Post deal, time is a luxury that neither party can afford.

The practicalities of combining PBBs are delicate and these deals, which can often involve an earn-out, have the potential to be highly destructive of shareholder value for each party.

Failure to plan the integration can be the result of faults on both sides:

Sellers

Owners have often spent much of their working life building up a business and are rightly proud of what they have achieved. Most are not natural employees and, as they are used to doing things their own way in their own business, fail to visualise properly how they will operate following a sale. In PBBs, the failure to plan is often exacerbated by the vendor trying to restrict access to key staff until the last moment.

Buyers

Being keen not to alienate sellers, buyers often shy away from potential difficulties which could be tackled most successfully at an early stage. As a result, problems may surface during the later stages of negotiations, causing the buyer to withdraw. This can dent the reputation of the seller and result in unnecessary costs and frustration being suffered by both sides. Alternatively such issues may come out after the deal is concluded, thereby causing personal resentment and loss of earn-out.

In a competitive situation it is natural for buyers to focus their efforts on completing the deal rather than looking beyond it. It should be remembered, however, that any fool can buy a business, whereas making a deal work requires real skill.

A positive legacy

No one will thank you for passing on your business with key matters unresolved. Issues sorted out up front will yield a high return for you and both protect and enhance your staff's careers.

ABOUT IMAS

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IMAS specialises in selling companies in the financial services sector. We only act for vendors, thus avoiding the conflicts of interest that can arise from acting for both purchasers and vendors.

Our clients are private companies, private equity firms and major quoted companies, and our transactions typically have a value between £3m and £50m.

Our clients benefit directly from our comprehensive sector knowledge, and we act in the sale of more unquoted financial services companies than any other adviser in the UK.

We were founded in 1992 and are authorised and regulated by the Financial Services Authority.

Better Informed

"Maximas is an excellent analytical tool. Anybody thinking about buying or selling in the financial services sector ought to talk to IMAS."

– Paul Pindar, Chief Executive
The Capita Group Plc

Maximas, our proprietory knowledge management tool, comprehensively analyses over 25,000 companies in the UK financial services sector, and links this to extensive other information.

Maximas is unique. It has been developed and refined over ten years and provides us with outstanding insights into the profile of buyers, trends and valuation in the sector.

To view the web interface go to www.maximas.uk.com

Better Advice

Our objective in selling a business is to maximise its value whilst maintaining confidentiality and minimising disruption to the business during the process. There is no second chance when selling a business, so it is crucial to get it right first time.

We aim to offer the best advice available in the market by:

- focusing on a single sector – financial services
- only acting for vendors
- having a highly-experienced team of professionals

Our unrivalled expertise means that we know:

- the drivers of value of a business, and potential transaction pitfalls
- the buyers to approach and those to disregard
- how far to push pricing negotiations
- the deal structures that protect our clients' interest.

Thinking about your options

We are always pleased to discuss, in confidence and without obligation, the options open to owners of financial services companies.

We believe that value is best served by planning ahead, so we welcome discussions at an early stage. If we consider that a sale is not appropriate or the timing is not right, we will tell you, and provide you with pointers to maximise the likelihood and value of a sale when it is.

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