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Trendwatch

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Profile

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It's who you know

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Weighting game?

With debt markets limiting private equity's purchasing ability, power is shifting to trade buyers. How should sellers' advisers change their approach to suit these conditions?

Tipping point

As credit conditions tighten, corporates are regaining their position as the natural buyers of businesses from private equity firms. **Tim Chapman** asks whether vendors and their advisers will need to change their approach to secure maximum value

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The past few years have been a great time to sell a business. Private equity firms have been buying at an unprecedented rate and at ever-larger deal sizes, while trade buyers have been aggressive bidders for the right strategic fits. Cheap credit and a stable economy encouraged both buyers and sellers, despite increasingly onerous due diligence demands and thorny issues such as pensions and environmental liabilities.

Spurred on by benign conditions, the sales market was also driven by the acquisitive hunger of both trade and financial buyers. But with market wobbles and credit clampdowns dominating the headlines, can this seller's market continue? And how will advisers need to position businesses and manage auctions to achieve the maximum price?

Headline figures reveal that the UK market has been fairly evenly split between trade buyers and financial buyers, although individual advisers report heavy weightings one way or the other. In many auction situations, private equity buyers enjoyed the upper hand, partly because they are set up to do deals and are often smoother and sharper on the deal process. "They know how to respond to processes and how to organise due diligence, and are very good at persuading vendors that they are the right choice," says Rob Donaldson, head of M&A at Baker Tilly. "In some ways, I think trade ought to sharpen up their act in how they deal with M&A opportunities."

Private equity buyers have also been able to leverage their way to higher valuations in many sectors. In the second quarter of 2007, the price-earning ratios paid by private equity acquirers outstripped those paid by trade buyers by an average of 25 per cent in hot sectors such as healthcare and business services, according to analysis by BDO Stoy Hayward. Financial services was the only sector where trade buyers paid higher multiples in the quarter.

Private and shy

This balance of power is sure to shift as the credit crunch takes effect. It's already meant the end of the boom time for the top end of private equity. "Very large deals are incredibly difficult to get done now because of the sheer volume of unsold loans that banks have on their books," says Stuart McKee, corporate finance partner at PricewaterhouseCoopers. McKee points to the much-delayed sale of the senior debt on the £11bn Alliance Boots buy-out as a vivid illustration of the problem. "That's partly because the banks to whom they would usually syndicate are sitting back saying there's no need to do this now because if they wait they can buy the debt cheaper in the secondary market. That's a slightly unusual situation," he says.

That extends to a lesser extent into the mid-market, across most sectors. For deals up to £50m-£60m, with debt of up to £25m, the crunch is a non-issue, says Alex White, corporate finance partner at BDO: "Banks are perfectly happy to hold that debt without even considering the need to syndicate. But once you're getting above £50m, banks want to look at clubbing a debt deal before completion. That has caused some delays to transactions we have in process."

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> *Rob Donaldson, Baker Tilly*

Several advisers report that credit problems delayed deals in process during the early autumn. "We've got a transaction where the buyer is getting funding for the deal and suddenly there's a need to syndicate it between two or three funders," says Donaldson. "In the past, it might be syndicated after the deal, but there'd be no question of it holding up a transaction."

Trade discount

With less need for outside debt, trade buyers seem set to gain the advantage in bidding for companies. In some recent sales, trade buyers have been making significantly higher bids than private equity. When National Britannia Holdings was up for sale over the summer, it was trade buyer Connaught that came up with the winning bid. "The fact that National Britannia has been bought by a trade buyer as opposed to a private equity house is a reflection of current market conditions and that synergy is once again outbidding leverage," says Peter Alcaraz, managing director at Close Brothers, who advised Lyceum Capital on the £91m sale.

"Trade buyers are feeling more self-confident and we're seeing a lot of interest from overseas buyers," says Howard Leigh, managing director at sales-only specialist Cavendish Corporate Finance. "They seem to be up for it, are happy to compete against UK people and see the UK as a market they want to be in." Overseas buyers are also coming from further afield. Among Cavendish's recent deals is the sale of AEI Cables, an engineering business based in County Durham, to Indian group Paramount Cables. "That, I think, is the first of many," says Leigh.

Trade acquisition activity remains a cyclical business, however, and the intense activity over the past 18-24 months might suggest that the current high is nearing its end. "Trade tends to enter a market at its peak and pay the highest prices," notes White. "Then if things get difficult they tend to go away a little. They're certainly coming in hard on pricing at the moment, but there's a lot of talk about valuations getting to the top of the cycle and that they must come down. The danger for private equity is forming a view that prices should come down, but actually finding there's competition in the form of trade buyers who haven't reached the same judgement."

The right buyer

Figuring whether a particular sale is best suited to a trade or financial buyer – or which is likely to pay the highest price – is a vital skill. It's often clear early on where interest is likely to come from – private equity likes solid fundamentals, good cash-flow and debt-bearing potential, while trade are more interested in the strategic benefits.

"There are businesses where it doesn't make sense to go to private equity, but I think that's much less the case now than it used to be," says Donaldson. "And there are some circumstances where the deal is more of a cashout for the vendor, so it doesn't make sense approaching trade."

There are also softer factors, such as the vendor's attitude or relationship to the incumbent management team. "Where we have vendors who like the idea of selling to their management team and perhaps don't want to engage fully with trade buyers in their markets, or the management team have influence in the process, that plays very well to private equity houses," says White. "But where you've got a very straightforward maximise-the-valuation-don't-care-who attitude, you're certainly seeing that private equity doesn't have so much of an edge in those transactions."

Many deals – up to half, according to some advisers – retain both trade and financial suitors well into the sales process. Running a process with two different

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Conquering Everest

A managed sale process led to an unconventional deal for home improvements group Everest. A stalwart of the mid-market, the Hertfordshire-based business was established in 1965 and achieved national fame in the 1980s with its unforgettable double-glazing adverts fronted by the late Ted Moult. After decades of corporate ownership, 3i backed serial entrepreneur Brian Kennedy in a £33m BIMBO of Everest from Caradon in 1998. That was followed by a £63m secondary buy-out in 2003, with backing from Bank of Scotland (BoS) Integrated Finance. Kennedy remained the majority shareholder.

Four years later, in April this year, BoS and Kennedy, now owner of Sale Sharks rugby club, were looking to realise some value and appointed PricewaterhouseCoopers to find a buyer. The business drew strong interest from both trade and financial buyers, says corporate finance partner Stuart McKee. "Trade interest went significantly down the road before the decision was taken to go with the private equity route," he says.

Among the financial firms invited to have a look was Hutton Collins, the London-based structured equity investor. Investment director Haseeb Aziz says Everest was an immediately attractive proposition: "It's shown a very solid and good growth over the past five years. It's obviously a brand that people are aware of, and they seem to be very good at expanding their product range and accessing the customer base. You understand where growth is going to come from and how profits convert to cash."

Rather than a complete buy-out, Hutton Collins offered a three-way ownership structure split between the fund, the incumbent management team and Kennedy. "I think our financing structures are slightly different, in that we have a minority stake," says Aziz. "You've got three interested parties and you need at least two out of three to drive the business forward, so it seemed a more equitable way of pushing the deal forward. Our style is more collaborative than saying we're going to have control."

That structure, combined with the strong price offered, made for an attractive solution. "The overall shape of the deal that Hutton Collins was able to deliver ticked more boxes than the trade option did," says McKee. "Part of that was a strong desire by the management team to enhance their stake and take the business further. That wouldn't have been a feature if trade acquired the business."

After a relatively smooth process, the final deal, announced in early September, valued the business at £150m. Hutton Collins took a 25.1 per cent stake while the management team, led by managing director Simon Jarman, increased their net stake from 11 per cent to 25 per cent. Kennedy reduced his holding from a controlling 66 per cent to a minority 43 per cent, pocketing some £35m.

BoS remained on board with a £100m debt package, something that the firm's newest shareholders take comfort in, given the debt turmoil during the deal process. "We got the right package from the incumbent lenders and there was no strengthening of terms of the banking package," says Aziz. "They continue to be very supportive of the business, which gives us a lot of confidence."

styles of acquisition management can be a challenge for advisers.

Making your mind up

Trade buyers are sometimes accused of taking too long to make decisions about whether to buy a business. While financial buyers are entirely set up to do deals, trade buyers' first priority is running the core business, rather than making immediate decisions on M&A opportunities.

But trade buyers are prepared to pay a premium for the right business – and that can lead to conflicts in the sales process. Do you accept the quick offer from private equity, or hold on a little longer to give trade time to get comfortable with the business?

In practice, that doesn't actually happen often. "It's rare that the first time someone's heard of a business you're selling is when you're calling them up and getting an IM out," says White. "Because there's that period of time where documentation is being prepared, there's more opportunity to get people on a more similar timeline." The warm-up period is also increasingly being used to prepare vendor due diligence (see box, right).

Stalling tactics

But it's increasingly the financial buyers who drag out deals once they're underway, with demands for broader and deeper due diligence – typically with more emphasis on market and management than a trade buyer would need. That increases the risk of a deal with a financial buyer being abandoned late in the process, as does an emerging trend of leaving the tricky bits until last.

"What people are doing more and more, particularly in private equity, is back-ending a deal – by which I mean they're not doing the heavy lifting and expensive work until the end of the transaction so they can keep their costs down," says Leigh. "With trade buyers, if they get the bit between their teeth they will buy it, whereas a private equity buyer will go right to the wire then say no. We normally feel a bit more confident with a trade buyer."

While the balance of power is likely to tilt towards trade, private equity will stay in the game and is unlikely to stay quiet too long, even at the top end. But lingering uncertainty about market conditions and a persistently tougher credit market will certainly not ease the sales process. "Things will just take longer because people will resist being forced into a process too quickly," says Donaldson. ■

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➤ Paying your own dues

Despite the increasing diligence demands, sale transactions aren't necessarily taking longer to complete. That's helped by increasing use of vendor due diligence, particularly in auction situations. By preparing the bulk of the necessary work before the formal deal process kicks off, sale advisers can help ensure that the deal is wrapped up within three or four months.

But not all potential buyers are equally comfortable with vendor due diligence. Private equity players are generally happy, particularly when they have ongoing relations with the diligence providers that would be damaged if the work proved inadequate. "It's something you can invest time and money in. We would suggest it for the right deal," says Baker Tilly's Rob Donaldson. "But it doesn't always work particularly well where there are trade buyers."

Trade buyers tend to mistrust vendor diligence and prefer to commission their own diligence as a substitute or supplement. "So long as it's a proper piece of work and deals with the obvious questions rather than skirting around them – which we have seen – it is useful, but there's always going to be a degree of top-up due diligence in most transactions in the mid-market," notes BDO Stoy Hayward's Alex White.

The two sides also differ in their willingness to commission vendor due diligence when selling a business. Most private equity sellers expect to commission vendor due diligence, but trade sellers, particularly entrepreneurial or owner-managed businesses, are less willing. "Effectively they see that as adding to a potential abort cost," says White. "They also do not entirely trust vendor due diligence. In all, they don't buy into the value it can bring to the process."