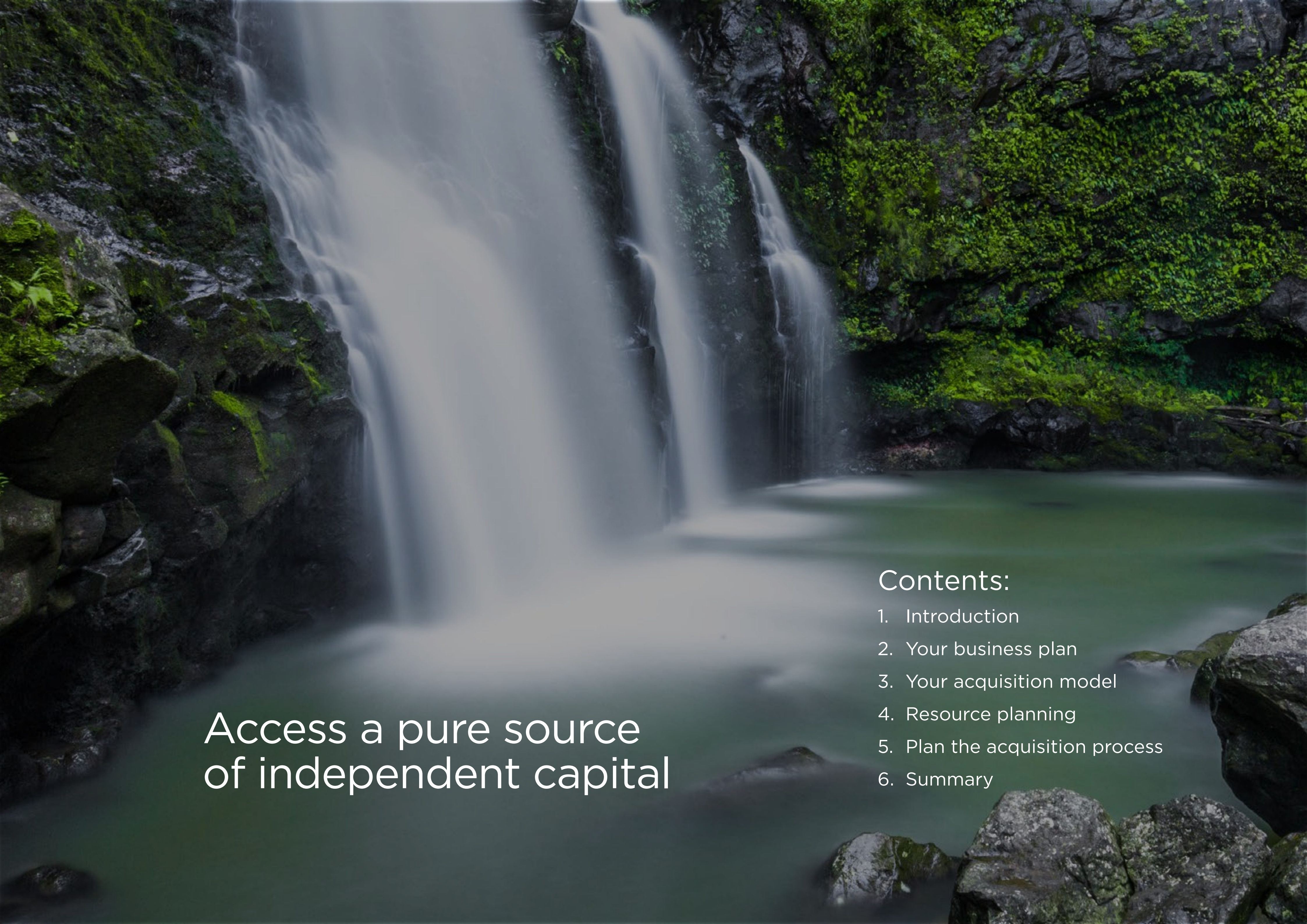
GUIDE FOR BUYERS

Grow your business through acquisition

VERTUS CAPITAL



Access a pure source of independent capital

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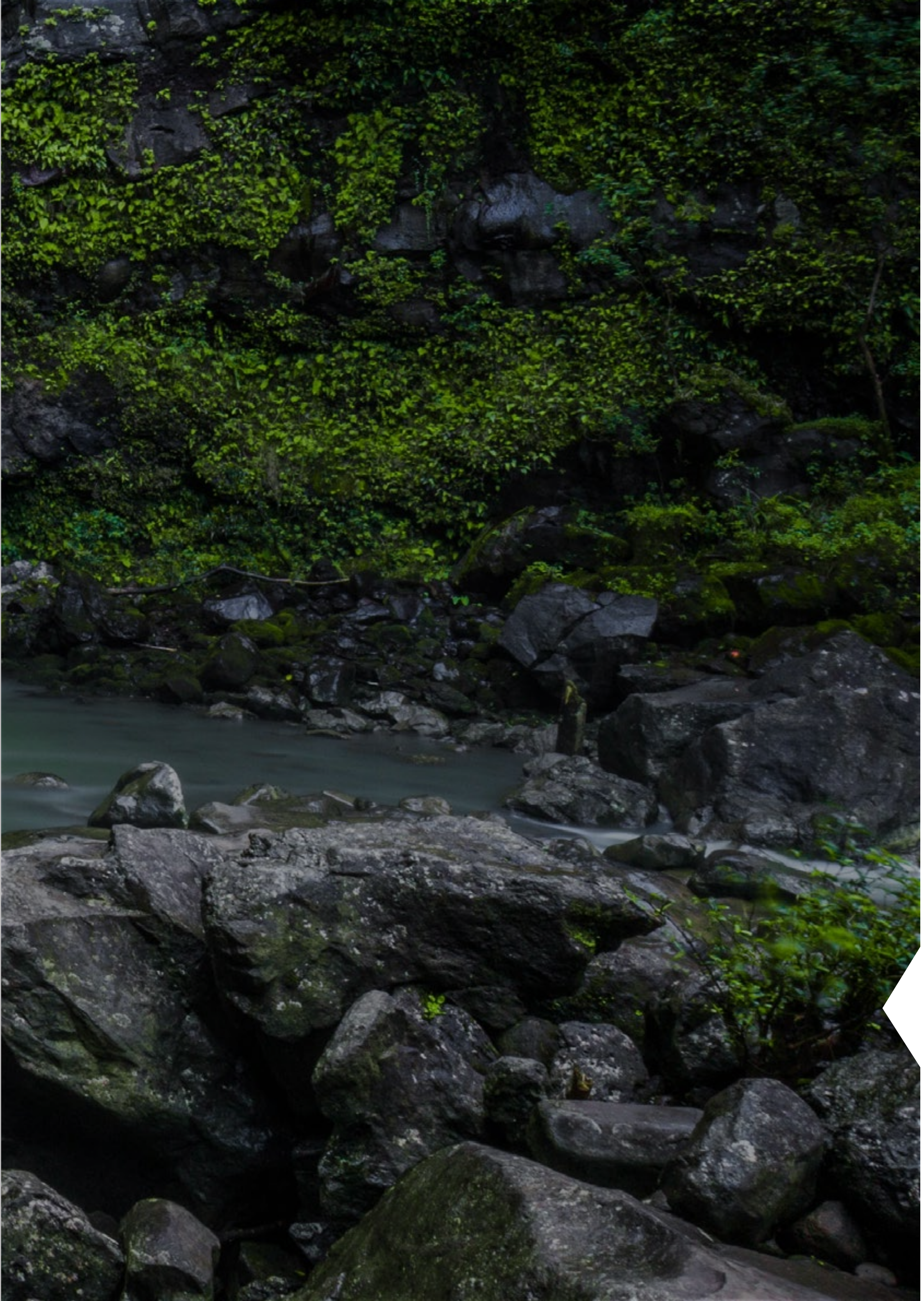

“Growing your business through acquisition can be a daunting and complicated undertaking, but the returns can be very rewarding. A successful acquisition strategy requires careful planning and consideration.

To help you plan yours, we have teamed up with Rob Stevenson of Kingmakers. Rob has significant experience in the acquisition of financial advice firms and together we have created this guide, designed to help first time and experienced acquirers alike. At Vertus Capital, we actively support simple, non-adversarial transactions between similar parties in the advice market. We call these ‘like-minded’ deals. In the interests of enabling like-minded deals to happen we have written a guide for buyers, which should be read by sellers too. Insight is essential for buyers and sellers and we welcome engagement from you as you embark on this exciting journey.

Matthew Marais of Vertus Capital

Your business plan

So, you want to grow through acquisition? Before you rush off with emails, coffees, meetings, and lunches with potential sellers, you should start with a period of introspection and planning.

Building a business plan for your acquisition strategy is time well spent. Your acquisition(s) will need to be integrated into your existing business, so it's essential to make sure your business foundations are sound.

If you look through the apparent complexity in acquisitions, success can often be reduced to two factors; price and fit. The first is obvious and we will come on to valuations later, but fit is where we start. Most acquisitions are driven by growth strategies and so it makes sense to target firms with a similar overall ethos, proposition, and investment philosophy. Finding a firm with the right fit to yours is crucial.

In order to find a great fit, you should take some time to ascertain exactly what it is you want, how it will fit into what you have and what impact it will have over a chosen timeframe. To frame this in financial terms; given price paid and terms, when do you expect to breakeven and what is the required return on investment over your desired timeframe. Acquisitions are business investments, so the decision to embark on an acquisition strategy should be supported by the case for such an investment. In other words, will these deals enhance your firm's top and bottom line, free cash flow and balance sheet, over time?

Assessing fit goes beyond just financial metrics. Other important considerations include the target firm's approach to financial planning, their investment philosophy, use of platforms, style of advice and so on. The closer you can get to your own proposition and pricing, the easier acquired clients will find the ownership transition, which will probably be the single most important driver of value for you. Geography is also an obvious consideration. Taking on multiple offices might seem like a good idea from a client continuity perspective, but the span of management control can quickly become stretched. Bear in mind that the period immediately post-acquisition is critical for the culture of your entire firm.

Once you have developed your business plan, you should develop a framework for your acquisition strategy, including an acquisition model, project plan and the outline of a typical target firm (incorporating your thoughts on size and shape). This will help you avoid being pushed and pulled in reaction to sellers' demands, not knowing when to say yes or no and possibly making commitments that could result in a sub-optimal outcome. With a clear plan, if you do deviate, at least you have a baseline to measure from.

We will revisit your business plan regularly throughout this guide and its importance on your acquisition journey cannot be overstated.

Your acquisition model

Your acquisition model must include what you intend to acquire, what you're prepared to pay for it and how.

Assets or legal entities

Let's start with whether you are looking to buy the shares or the assets of the seller. No two businesses are the same and there are advantages and disadvantages to each option. What you can do is explore which type of transaction might favour your business and then open all negotiations with absolute clarity regarding what you intend to buy.

The Vertus Briefing Note titled What are we selling? provides a useful summary of the main differences between the two approaches and is worth reviewing as you consider your optimum approach. When considering whether to purchase the assets or the legal entities, the primary risk you want to avoid is ambiguity at the point where a price of the seller's business is being discussed. The moment you mention a price, the seller will anchor negotiations to that price. If they believe that price is gross of Entrepreneur's Relief, then they will quickly calculate the net consideration and often become attached to that number. If it transpires that an asset acquisition is being proposed, the seller will have a very hard time reconciling the additional costs associated with disposing of assets (tax and wind-up expenses). Misunderstanding what is being purchased can erode goodwill between the parties and is entirely avoidable if you factor it into your acquisition model and communicate it upfront.

Valuations

There are many ways to value a business and this guide sets out a basic process that could be utilised by both parties to negotiate in good faith. In simple terms, there are two main types of valuation; a backward looking multiple of historic performance, or a forward looking net present value of forecast cashflows. The former could include a multiple of historic revenue (typically recurring income for advice firms), a multiple of EBITDA (earnings before interest, tax, depreciation and amortisation), or a percentage of assets under advice (better suited to those firms with discretionary permissions). The latter (net present value) is a forecast of future free cashflow, discounted using a value that represents the purchasers' cost of capital and view on risk.

Whatever basis you plan on using, you will need some data from the seller. As a minimum it makes sense to ask the seller for detailed financial statements for the last two years (this will give you three years of figures) and an estimate of the current year's performance (this could be management accounts). In addition, you will need to clarify how the owner(s) take money out of the firm, so you can assess the likely future earnings of the firm (relevant to the EBITDA valuation in particular, more on this below). This data should allow you to get a good idea of the base values you intend to multiply.

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The percentage paid as initial consideration is critical to the offer. It is sensible for the buyer to defer some of the consideration, to help manage the risk inherent in the handover of goodwill.

In addition, one generally requires information on the clients (ages, life stages, average portfolio size, typical investments, etc), client service proposition (depth of financial planning delivered, investment management philosophy, strategy and solution), marketing efforts and results, the internal team (total headcount, roles, payroll, length of service, etc) and an overview of regulatory returns (basic returns, complaints history, and PII renewal). This data should give you a good idea of the fit with your acquisition model, and the valuation you are willing to pay.

Multiple of revenue

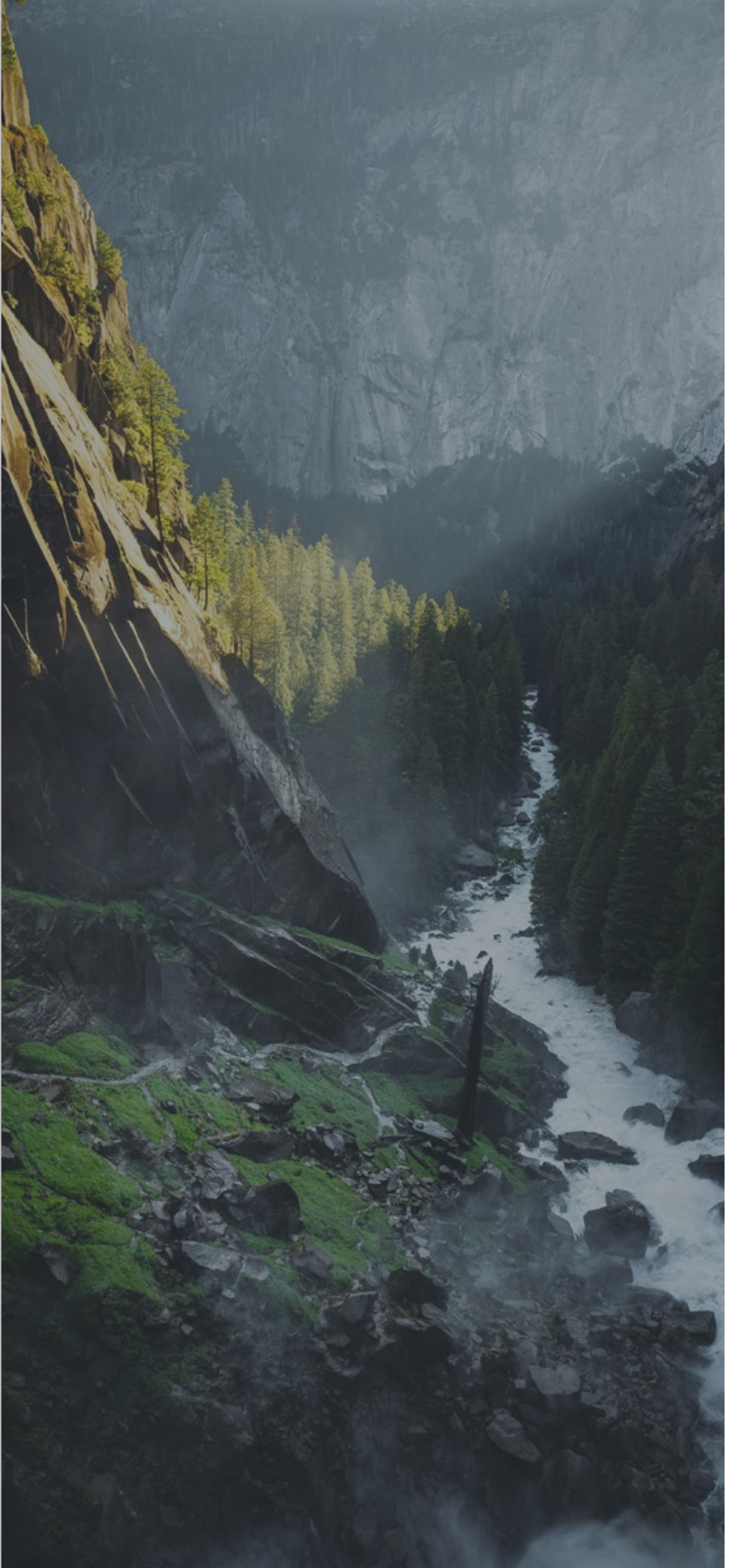
This type of valuation is perhaps the most familiar, as it is easy to calculate. Determine the types of revenue you wish to include (generally recurring income, but a lower multiple can be placed on other income streams in some situations), decide on the appropriate data set (using the current year and the last two complete years is normal and you can use either a straight average, or a weighted average) and apply your multiple. At the time of writing, somewhere around three times is common.

Multiple of profit

Multiple of profit (earnings before interest, tax, depreciation and amortisation or EBITDA) is a more accurate valuation methodology because it focusses on what returns the business will generate for you when adjusting for likely expenses. This one can be a little tricky because the EBITDA must be adjusted to reflect what the picture will look like going forward (this process is called ‘normalising’). In very general terms, owner/operators like to manage their tax position by minimising basic salary and receiving dividends. This gives an inflated profit figure, which must be adjusted to reflect future maintainable earnings. In addition to agreeing the amount of compensation for the owner after the transaction, adjustments should include one off expenditure. Once you have an agreed number that represents the likely picture for the coming year(s), apply the multiple. A starting point might be four times for a small firm (single adviser), rising to seven times for a firm with multiple advisers and perhaps venturing higher for something of exceptional quality and perceived fit.

Percentage of assets under advice

Typically reserved for firms whose core proposition is investment management, this valuation is simply a question of agreeing the assets under advice figure to be used (what assets are included, which years to include, and what weighting) and then applying a multiple. Several firms track published transactions in this market and the multiple has hovered around two percent for the last decade.



Discounted cashflow (DCF)

This valuation is rarely used by a seller, as the discount factor is very difficult to determine, depending as it does on the weighted average cost of capital of the buyer and the risk premium, both unknown by the seller. If, however you are planning a series of acquisitions, you should take the time to create a DCF, as it will force you to contemplate the assumptions you are making with regard to the future performance of the acquired assets, inside your firm.

From valuation to offer

A business is only worth what someone is prepared to pay for it. Remember that you are not only trying to determine a value, you are trying to combine value and terms in an offer, and it's at this point in the process where you move from valuation to offer. There are several factors that frequently determine the actual price paid and these are reflected in the terms, such as the balance between initial and deferred consideration, the amount of cash in each type of consideration, the contingent nature of deferred consideration (or not), security and interest on deferred consideration, and the sellers' role and compensation if working on in the buyers' firm.

Initial consideration percentage and composition

All a seller can really count on in a deal is the cash in the bank at completion. The percentage paid as initial consideration is critical to the offer. It is sensible for the buyer to defer some of the consideration, to help manage the risk inherent in the handover of goodwill. Many deal structures offered by established consolidators pay less than half of the consideration upon completion. This is an opportunity to demonstrate a clear difference between a like-minded buyer and a consolidator, by paying a sensible percentage of the overall consideration at completion. Consider paying 50% - 60% of the consideration upfront to make it a meaningful capital event for the seller.

As far as the method of payment is concerned, cash is king. Offering equity in your business creates uncertainty for the seller, who would rather have cash in the bank. Of course, if your acquisition model includes the use of equity as a replacement for cash, then you will obviously want to consider offering equity as part of the initial consideration. If you do, just make sure you have a clear value plan for the seller and can separate yourself from similar stories, told by private equity funded, vertically integrated consolidators.

Deferred consideration terms

One of the main issues to consider with deferred consideration, is whether to include an element of contingency. Consolidators frequently take account of the acquired firm's future performance (inside their firm) and decrease the deferred consideration payable accordingly. Where a significant percentage of the overall offer is deferred consideration, contingent deferred consideration can make a mockery of the overall offer price. The seller won't know what they actually received for their business until all the contingency calculations have been completed. This increases the risk for the seller. Furthermore, applications for Entrepreneurs' Relief were based on the total consideration agreed on at completion, and amendments can result in a recalculation of tax relief at a later date. Another opportunity to differentiate your deal is to limit contingency adjustments. As an example, this might include the loss of specific large clients, but would stop far short of a profit hurdle, and should certainly avoid a wholesale movement of the seller's clients, to the buyer's central investment proposition.

As the deferred consideration is technically a loan, sellers (or more often their lawyers), may ask for interest on the deferred amount. This is usually dismissed where contingency exists, so if contingency was limited, you could offer interest on the deferred element of the consideration and again, stand apart from vertically integrated consolidators. It also helps to demonstrate certainty to the seller by providing an institutional letter of support from your lender, if you are borrowing money to finance the transaction.

Owner's situation after exit

What happens to the owner of the firm after you have acquired it. Ideally, you want an orderly handover of the goodwill shared between the owner and their clients, but should the relationship stop there? Many advice firm owners want to spend the last few years of their career, doing what they love. Selling their firm means they are free from admin and compliance issues, which is all upside. But in many instances, they would love to continue seeing their clients. While the goodwill handover must happen, it could be timed over several years. During this time the seller could play an ambassadorial role to help with the acquisition of new clients, and potentially develop younger talent inside your firm. Decide what you want, discuss and agree a role with the seller and the terms of compensation that go with it.

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Resource planning

Once an acquisition process has begun, it takes on a powerful momentum, which needs to be maintained for all involved to feel confident, engaged and motivated. This pace is easily disturbed and that can be damaging for all parties. It is good idea to plan out the resources required prior to commencing activity.

Internal deal team

There needs to be an individual who is ultimately responsible for the deal. Owners need to decide who is in charge and let them take the lead. They need to be realistic about the time the deal will take and plan their available time accordingly. If you are leading an acquisition and also have client responsibilities, you are in for a busy few months. It is helpful to appoint some dedicated admin capability to support the deal lead, as the admin burden is significant.

External advisers

You are going to require a lawyer and appointing one early can save time and money later, as they can help you with the planning process. Try to find a firm that has experience in this space, and understand the nuances such as regulatory requirements, deferment, goodwill, and warranty detail.

You will likely require tax advice and perhaps some assistance around acquisition strategy, deal structuring, and negotiations. There are a small number of firms that specialise in these areas, so it's worth looking for a team with specific experience. If you chose to use a broker (perhaps to locate acquisition targets), then make sure you have clarity on who they represent, and how they will be remunerated.

Fund raising

If you need capital to complete planned acquisitions, it's a very good idea to arrange the facility as early as possible in the process. While the process can be a quick one (where you can supply details of your business plan, forecasts, and acquisition model, there can be issues that need to be resolved and it helps to be able to demonstrate capital availability to a potential seller at your first meeting.

Collateral

If you are planning to undertake multiple acquisitions, develop some marketing collateral to explain what you are looking for and why your firm would be a great home for the seller's clients. While you may have client-focussed marketing collateral, that's not quite the same message as the one you want to convey to a prospective acquisition target.

If you are embarking on a series of acquisitions, you should develop systems, processes and templates to make the activity easier each time. Examples of this would be valuation models, non-disclosure agreements, legal templates, and due diligence checklists. This shows the seller that you know what you are doing, and they are in safe hands. You might develop these resources as you go.

Plan the acquisition process

Plan out how you might implement your acquisition strategy and execute individual transactions.

Finding suitable firms to acquire

It is important to find firms that fit your intended profile. An obvious place to start is your own contacts, so extract them into a spreadsheet and do some desktop research to see if there are any matches close to home. If you are a Transact user, you can utilise their matchmaking service by simply completing the necessary proforma to register. Inside this community they are working hard to match buyers and sellers, so they may be able to do the hard work for you. In addition, you could contact representatives of other providers, write articles for the trade press and professional associations, or even contact firms you are interested in directly. Put a few pages on your website outlining your acquisition plans and publish some related content that you can draw business owner's attention to.

Negotiations and heads of terms

If you've done the hard work up front, you will be able to set out a clear timeline with a prospective seller and in this way, negotiations can be focussed and well-managed. This will help you to avoid open ended discussions where neither side are clear on what they want or are prepared to offer. If you can make a clear offer, provide timelines for each stage with clear milestones to control the negotiation phase for the benefit of all involved.

You need to gather enough data quickly to provide an indication of interest and approximate terms. This will be documented in a heads of terms. Once signed, this document should limit the sellers' ability to negotiate with any other thirds party without breaking off negotiations with you. This will protect you as you move into due diligence and commit further resources.

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Due diligence

When you move into due diligence you should be clear on the process. Managing expectations is crucial with an intrusion of this magnitude. In due diligence you are verifying all claims made by the seller in negotiations regarding the firm’s finances, clients, proposition, processes, team, regulatory position, assets and liabilities, and anything else that you deem critical to the transaction.

Many sellers get upset during the due diligence process. Due diligence frequently raises material points for discussion. The report is created for the buyer (at the buyer’s costs) and the seller may be disappointed when they don’t get a copy of the report. The more clarity and certainty you can provide to the seller upfront regarding the process, the better.

Amending the terms

If the due diligence reveals material discrepancies from what was originally represented by the seller, you have a right to amend the terms of the original offer. Due diligence is there to establish the facts and there is often a chance the owner is unaware of the actual state of some aspects of their business. Therefore be sensitive in raising these differences and look to conclude any amendments to the terms quickly.

There are occasions when due diligence will reveal a potential deal-breaker. As you plan your acquisition activities, identify these deal breakers in advance, so that you can act decisively should they arise. It’s easy to get emotionally tied to a transaction but remember that there will be other deals.

Legals

If all is well, you now move into the production and negotiation of legal matters. This is going to include the production of a sale and purchase agreement (the main acquisition document, among others), which is the purchasers’ responsibility to produce. Exact requirements change from deal to deal, so clarify with your lawyer before drafting commences.

One area where significant time can be lost, is the drafting and re-drafting between lawyers. If this situation is not carefully controlled, one can experience style changes that don’t alter the substance of the legal documents but do delay them and can cause significant additional costs. Communicating with both lawyers at the start of this process, reaching clarity on the rules of engagement can save cost and prevent delays.

Completion

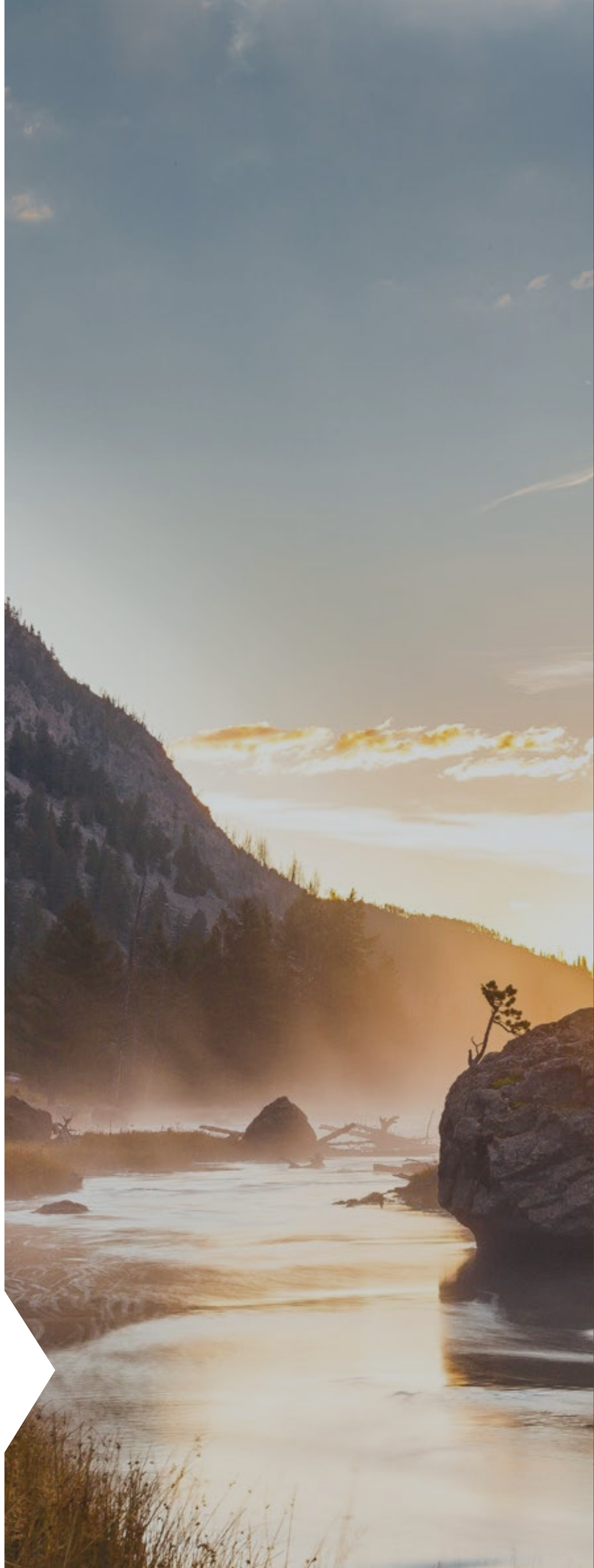
Your lawyers will guide you through any third-party and regulatory approvals required.

Once you've gone through all this once, you will know what's needed in advance and can build this into your processes. Notifications and communications need careful planning. Focus these on clients, staff, third party suppliers and the press. Preparing funds to be drawn down and arranging bank transfers should be done well in advance, as any issues here will almost certainly delay completion.

After completion

The priority after completion will be data integration and the arrangement of joint meetings between you (and your advisers if you have them) the seller and the clients. Make sure key members of staff meet as quickly as possible to work on integration plans. There will numerous post completion items, such as regulatory filings, completed legal documents (your lawyer may circulate a deal bible) and professional fees to handle.

Don't neglect your deal post-completion. Focus on the clients and employees to ensure a transition with minimum disruption. Make sure that all parties keep up their part of the agreement! It is wise to maximise the value out of your existing investments before taking on more.



Final thought

There are significant opportunities in the advice market for independently minded firms to engage in like-minded acquisition deals to grow their firms. However, growth through acquisition is not business as usual. It requires intent, focus, and strategic planning.

You are more likely to grow successfully through acquisition if you define your growth objectives clearly in a business plan and strategy. You should expect the process to significantly increase your workload as a team and you should prepare for this at the outset. The more thorough your planning, the more successful you are likely to be. If done right, growth through acquisition will generate very good returns. Targeting businesses that are the right fit, at a fair price for all parties, is key to success. If you target the right businesses by focusing on continuity and value for clients, each acquisition should enhance your business value, not detract from it.

Get this right and many other challenges are dealt with in short order.

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