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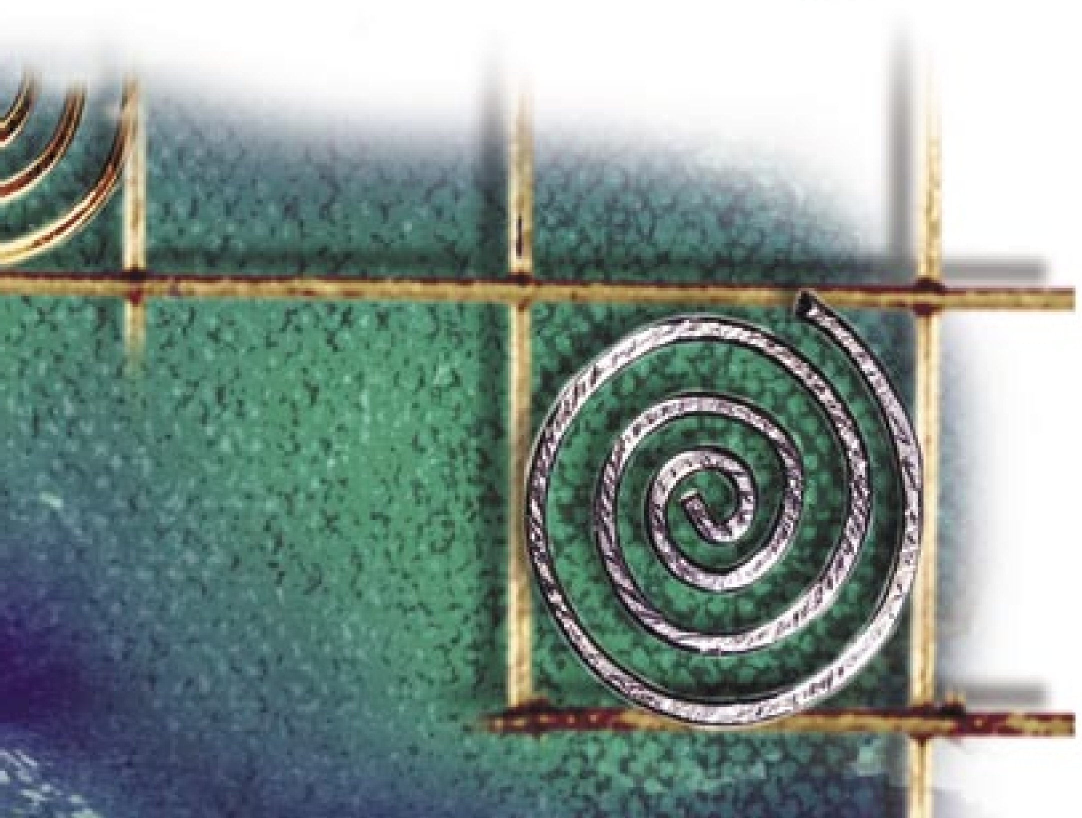
Accountants &
business advisers

Extracting value from your business

A guide to exiting your company on your terms



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Our clients benefit from an integrated approach based on understanding the key issues facing small and medium sized businesses. This enables us to meet their needs at each stage of development and allows them to focus on building
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The principal services we provide include assurance and advisory; consultancy; corporate finance; corporate recovery and insolvency; forensic and taxation. We also offer financial services through our FSA authorised company, PKF Financial Planning Limited.

We have particular expertise in the following sectors:

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Introduction

Eventually, 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 even though 45 per cent want to retire before they reach 50.

The aim of this PKF booklet is to provide some basic advice on exit planning for the apparent majority of business owners who are currently avoiding the inevitable and to outline the main routes available to you.

The first piece of advice is that it is never too early to start thinking about exiting your business. In fact, it can be argued that even your original business plan should include a section on your endgame and this exit planning strategy should be updated throughout the life of your business.

It is also important to realise that succession and exit planning is not a single event but a deliberate, tailored process that requires planning, teamwork and constant re-evaluation.

A valuable side effect of the exit planning process is that it can help you to identify and set your own unique personal and financial goals and decide 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.

Even if your planned retirement date is a long way off, understanding the process now can help you run your business in a way that will make it easier to leave – in optimum financial shape – when you are ready. 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.

When considering succession various options exist. These include disposing of the company through a 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); a stock market flotation; or voluntary liquidation.

In contrast to these considered strategies, an all-too-common option is the “keep going until you drop” approach – which is the worst possible way of leaving your business. If you wake up one morning and decide that you want to leave the business now, you are far more likely to take the first available deal which 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 so. Typically, many companies reach a growth plateau after a few years, particularly if you have built your customer base on the existing contacts or previous customers of the owner-manager, directors or partners. This approach is known as “address book marketing”. Although it may have provided an initial customer base on which to get the business off the ground, your address books may now be exhausted and the time has come to look further afield for new customers.

Perhaps now is the time to consider your options for exit – on your terms.

Chapter one

Why, when and how are you going to leave your business?

For the vast majority of business owners, the dream scenario of simply selecting a retirement date and picking up their pension from that date onwards is a fantasy. Without planning, this just will not happen.

You must be clear about what it is that you want to achieve. Before you start planning, you should ask yourself the following questions:

- *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 you want to do in your retirement? Do you want to keep your hand in as a business consultant, buy yourself a villa in the sun and take up golf, take on a number of non-executive directorships, learn to play the guitar, or sail around the world? Only you know what you want to do so you have to be personally involved in the development of any exit plan.*
- *How much income will you require to support your retirement plans?*
- *How will that income be funded?*

- *Will your current pension plans be sufficient to support your retirement?*
- *If not, how much are you going to rely on the proceeds from a business sale to supplement your existing pension?*
- *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 there other shareholders or partners to consider?*
- *Are you likely to survive in good health until retirement age is reached?*

Even though 45 per cent of business owners claim to want to retire early, the fact is that owners of small businesses tend to work longer – largely because they gain considerable personal satisfaction from running their own business. So, although they may wish to exit from one business, the likelihood is that they will continue to involve themselves in other businesses or organisations well beyond the conventional retirement age.

As the business owner/shareholder, you are the only person who can answer these questions that will form the basis of your exit planning strategy. However, once you have answered them, you must also recognise that external factors beyond your control may well get in the way of realising your objective. You need to adopt a flexible approach so that your plans can adapt to changing market or personal circumstances.

You are also likely to need external, professional help to realise your goals, particularly if you are intending to sell your business. Your future may depend on realising the best possible price for your business and you will only have one chance to get it right. Your chances of achieving a good deal will be considerably enhanced by using a good team of advisers who understand the marketplace, the real value of your business and how 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 that you have available, you may need an external adviser to help you with some or all of the following:

- *An initial assessment of the operational processes within the business, including a review of the functional areas of the business, the external influences on the businesses, and existing retirement arrangements such as pension plans*

- *A company valuation based on the state of the company's finances and the current relevant factors in the marketplace. One of the objectives of a professional adviser is to bridge the gap between what an owner thinks their company is worth and what a buyer might be prepared to pay for it*

- *The development of a marketing plan for the business that identifies the best ways of putting the business on the market and the communications tools and activities that it will need to attract the right buyer*

- *The production of an imformation memorandum containing all the relevant information required to present the business effectively and convincingly to prospective buyers*

- *Identifying and contacting prospective buyers using their knowledge of the marketplace and their insight into individual companies' ambitions and needs*

- *Handling negotiations between you and prospective buyers to ensure that you get the best possible price for your business*

- *Minimising your tax liabilities and maximising your personal investments.*

PKF top tips

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

- *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.*

- *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.*

- *Only hire them if you think you can work with them. You need to feel comfortable with the individual(s) as you could be working closely with them for a considerable period of time and may need their shoulder to lean on when the situation becomes difficult.*

- *Make sure that you are speaking the same language. Many specialists are so focused on the technicalities of what they do that they forget that in this area you are essentially a layman. If they can't communicate clearly with you so that you fully understand the process, don't hire them.*

- *Ensure that you fully understand and agree the basis of fees to be charged by corporate finance advisers. Fees will normally consist of an up front retainer with a success related element payable on completion of the sale.*

Chapter two

Developing the exit plan

Once you have thought through your personal motivations and timing for leaving your business properly, you should also think about the external factors that will influence your strategy.

For example:

- *What is happening in your sector? Is it growing, shrinking, consolidating or fragmenting?*
- *Where are your products and services in their own lifecycle? For example, if you are in the video player business, you 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?*
- *Is there any legislation on the horizon that could have a detrimental impact on your business?*

When you have taken these external factors into consideration, your best exit option should evolve naturally from your analysis. For example, if your son or daughter has been working with you for several years and has reached the level of experience and management skill to equip them to take on the business, then it will be an easy decision to pass on the business to them.

If your life's goal has been to make a large amount of money either to fund your retirement lifestyle or to set up another venture, then you are more likely to favour selling your shares in the business for the best possible price.

At the other end of the spectrum, if the products or services of your business have reached the end of their lifecycle and there is no longer any market demand, you may consider a solvent liquidation to be the best option.

Although these are the three most common exit routes for an owner-managed business, this booklet outlines all of the following options:

- *Trade sale*
- *Keeping it in the family*
- *MBOs, MBIs and BIMBOs*
- *Flotation*
- *Winding up*
- *Innovative solutions.*

An exit plan does not have to be documented but you do have to keep your finger on the pulse of what is happening in the marketplace, as this could affect your ability to realise your goal.

Be prepared to take decisive action quickly if there are signs that your market is going flat. Timing is everything – particularly if you are planning on selling the business. Statistics show that the right time to sell your business is when it is still on its way up so that you can leave a new owner with the opportunity for further growth and larger profits.

From a commercial perspective, the best time to sell your business may arrive before you had planned on exiting the business, so you will need to weigh up the pros and cons of selling at a time that may 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. Here are two pieces of basic advice:

- *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 the company, review the taper relief position sooner rather than later and take any corrective action that may be needed to remove any "tainted" assets from the balance sheet.*

Always refer back to your exit plan when making investment decisions. If you want to retain any property used by the business after the sale or do not think that a prospective purchaser will value it, consider extracting it from the business at an early stage. You could then buy replacement assets in a different vehicle and rent them to the business.

Chapter three

Valuing your business and grooming it to boost value

The first thing that an owner should realise is that your business is only worth what the highest bidder will pay. Your view of what your business is worth may be very different from that of a prospective buyer, and a business that is heavily dependent on one person, product or customer may be difficult, if not impossible, to sell.

You have to be realistic and timing will be everything. Deciding when to sell will not always be obvious to you. Age, illness, family pressure or business problems often dictate timing whereas the best indicators should be the financial climate, buyer profiles and market trends.

Sale prices are not generally a function of historical accounting facts. Instead, they are more likely to be determined by the current profitability, expected future earnings and the risk involved in achieving those earnings, given the company's situation at the time of the sale.

When valuing your business, your advisers will look at the following:

- *The business history and its future prospects*
- *Cash flow, turnover, efficiency, costs and profitability*

- *The performance of similar types of business in your sector (benchmarking)*

- *Recent deals in your sector.*

A good corporate finance adviser who knows your sector will be able to value your company using this mix of historical, financial and market information.

The best time to sell your business is just before it has reached its full potential. Buyers all like to purchase something that they can further develop and squeeze more value out of. The trick is to ensure that your business is in good financial shape but leaves room for purchasers to make efficiency or cost savings that can boost profitability. Turning a company round is often a part of the challenge that buyers are looking for. Therefore, if your business is already performing at optimum efficiency and cost-effectiveness, it may be more difficult for them to make a mark (or money).

Having said this, it is important that your business is attractive to potential buyers, investors and lenders who will be looking at a number of "value drivers" to assess its value. An integral part of your exit plan should therefore be to focus on achieving a number of universal and industry-specific value drivers.

Universal value drivers

- *Increasing cash flow*

- *Developing operating systems that improve sustainability of cash flows*

- *Reducing debt*

- *Documenting sustainability of earnings*

- *Implementing a strategy to grow the company*

- *Building a strong management team*

- *Grooming a successor.*

Industry-specific value drivers

- *Stability of growth within the sector*
- *Inherent growth rate*
- *Return on working capital and receivables*
- *Inventory turnover*
- *Technical expertise*
- *Diverse and loyal customer base*
- *Effective corporate structure*
- *Motivated and skilled workforce.*

While your grooming activities should be appropriate for your business rather than aimed at a radical transformation, there are three key pieces of advice that PKF always gives its clients:

1. *Remember that selling a business can take up a great deal of your time and you will not be able to concentrate properly on running the business. You will therefore need to have a senior member of staff in place to ensure that the day-to-day operation of the business continues without disruption to customers, suppliers and staff.*

2. *Make every effort to keep your key people – particularly if you are in the service sector. Without them, your business assets will be considerably diminished and it could be difficult to find a buyer. Consider giving them share options to incentivise and motivate them.*

3. *Do not make any major investment in new product development, systems or property that drains cash out of the business without necessarily adding value to the potential buyer.*

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

- *Boosting your sales figures by aggressive marketing or customer promotions*

- *Ensuring that your information systems are up-to-date and transparent so that a potential buyer can feel confident of the financial reality of the business*

- *Formalising contracts with key staff, customers and suppliers.*

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. Many people assume that you will only have to pay a 10 per cent rate of capital gains tax but it is important to remember that this only applies if:

- *The asset you are selling has qualified as a business asset for the entire period you have owned it since the taper relief provisions have been in force*

- *You have owned it for at least two years.*

Often shares in trading companies can be tainted for taper relief purposes by substantial non-trading activities, such as owning investment property or having surplus cash or other investments. As a rule of thumb, H M Revenue & Customs interprets "substantial" as being over 20 per cent. When developing your exit plan and grooming your business, keep an eye on any non-trade activities that may need to be stripped out to protect your taper relief "clock". This is an ongoing issue and not one which can be fixed at the last minute if a problem is identified. Taper relief can be complex, so advice should be sought from your tax advisers.

You should also bear in mind that, if you sell business assets from the company, you may not have a capital gain at all. The company may be liable for corporation tax on chargeable gains and you may find that you will have to pay income tax depending on the way in which the proceeds of the sale are extracted from the company shell.

Of course, your tax position depends on the type of consideration received on exit. Deferrals of tax are often available, particularly for paper deals and there is usually some scope for rollover particularly if you use the Enterprise Investment Scheme (EIS). You should discuss these options with your tax adviser.

Chapter four

Exit route 1: The trade sale

Selling a company is a specialist area and to achieve a successful company sale takes considerable skill, time and effort. Even with the right professional help, there is no such thing as a guaranteed sale. Many company sales take between one and two years to find the right buyer and some companies never sell at all, despite best efforts. To achieve the best chances for achieving a sale at the right price, we always advise an owner to allow a timeframe of two years.

If you have decided on the trade sale exit route and have prepared your business for scrutiny by potential buyers, you are ready to start marketing the business for sale.

Together with your professional adviser, you should develop a marketing plan that will include the following steps:

- *Research potential buyers – competitors are likely to be your first targets – and draw up a list of realistic buyers and decide who to approach first*

- *Instruct your legal adviser to draw up a confidentiality agreement for interested buyers to sign*

- *Prepare an information memorandum for your business that includes a detailed business plan and strategic projections for at least three years, and a short one or two page profile giving key information on the business, but not revealing the company's identity.*

- *Forward the summary (via your adviser to maintain confidentiality) to potential buyers, to seek expressions of interest and importantly, confirmation that the interested party has the funding to make the acquisition.*

- *Draw up a short list of the most plausible buyers and send out the information memorandum to the researched list of potential buyers inviting initial offers to be made.*

You should also ensure that any issues which could endanger the sale of your business are overcome before you put the business up for sale. This includes any tax investigations or legal action being taken against the firm.

You now need to decide what you want to sell: the shares in the business or the trade and assets of the business.

Once you have reviewed the offers, you will move into the next phase of the sale, which would typically consist of a meeting with the most acceptable potential buyers to get a better understanding of their offer and proposal for the business.

You may then invite a further round of offers before finally deciding upon a preferred bidder to conduct due diligence and enter into contract negotiations.

Here are some guidelines to ensure that you get the best deal:

- *Whatever the logic put forward for the offer price, it is just a starting point for discussion*

- *Creating competition between potential buyers is a sure way to encourage higher bids. Don’t forget, more than one buyer makes for an auction – and auctions generate higher prices*

- *Clinching a deal with the most attractive bidder can be a drawn-out process. Don't be seduced by an eye-catching package without checking that the details are genuine*

- *Ensure all infromation provided is accurate and do not withold material facts. Surprises arising in the due diligence process can materially affect the buyers confidence (and the price).*

- *Both you and the buyers must be open about what you expect from each other, such as liabilities, responsibilities, form of payment*

- *Once you've chosen a buyer, draw up Heads of Terms so that you can achieve a basic signed agreement. Inform the other bidders that they have not been successful, but try to keep on friendly terms just in case the preferred deal does not proceed.*

- *Agree a timetable for the sale*

The sale of trade and assets rather than shares

You may find a potential buyer who wants to buy the assets of the company rather than the company itself. As a general rule, it is often less tax-efficient for you to sell the assets of the company rather than its shares.

Our advice is to take adequate advice before accepting such an offer so that you have a clear understanding of what proceeds you will receive after the company has sold the assets and you have extracted the cash from the company.

Tax implications to consider

Sale of shares

A sale of the shares in your company will be a capital gains tax disposal. You will need to consider what taper relief is available to you. This will depend on what the company does and how long you have owned the shares.

The offer for your shares may not be in cash. The purchaser may want you to take some of its paper (shares), in which case you should be able to roll your gain into the new shares. In some cases this may be attractive although you will then be subject to the volatility of a larger group's share price.

Many purchasers of shares 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 as employment income. This is an area fraught with uncertainty and requires careful advice.

Sale of trade and assets

Any sales of assets by a company could lead to double taxation: corporation tax on the gains in the company and income tax to be paid by the owner on any cash extracted. A more tax-efficient way for you to extract funds may be through the payment of pension contributions if this fits in with your plans for the future.

All business owners need to take account of balancing charges where assets (on which capital allowances have been claimed) are sold or trading ceases. Depending on the asset values, these can add to the profits of the last trading period.

If you take this route, you could retain a business property and simply sell the trade. This would allow you to retain an ongoing income from rent(s).

You may be able to defer capital gains tax by reinvesting the cash into another business that qualifies under the Enterprise Investment Scheme (EIS). However, you need to invest within three years of realising the gain. The deferral option is no longer available for investments in Venture Capital Trusts. If you are not taking a major stake in the new business or going to be involved in running it, you can also qualify for 20 per cent income tax relief on up to £200,000 of your EIS investment.

Chapter five

Exit route 2: Keeping it in the family

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

The process requires planning, teamwork and constant re-evaluation if it is to have any chance of success. Even the statistics are against you – 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. This is not only a sad fact for the families concerned but also for the nation's economic health, as much of our economy is composed of small, family-owned businesses.

If the business of succession is not done by process (planning), it will be done by crisis (failure to plan), with potentially disastrous results.

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, who 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 company 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 as decisions are often made on emotional grounds or to avoid family arguments rather than for sound business reasons. While the most obvious person may be the eldest son, he may not necessarily be the best choice for the company. It may also be tempting to put different children in charge of different parts of the firm to demonstrate equal treatment but, as this route can cause problems later on, it is advisable to select one main successor.

Here are some guidelines to follow:

- *Be honest with yourself when analysing the strengths and weaknesses of potential successors. Try to separate issues of family loyalty and fairness from issues of business acumen and strategic management.*

- *Ask yourself the following questions about your potential successors:*

  – *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 company?*

- *Be prepared to appoint members to your company's Board of Directors who are objective and outside the family ownership circle.*

- *Have regular strategic planning meetings that include both family members – particularly those who will succeed you – and key employees who aren't family members.*

- *Conduct all discussions with your family about the succession at work rather than at home and 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, including lawyers and accountants, who have experience with closely held businesses, complex corporate matters and estate planning.*

Once the choice has been made, the person should be fully prepared for their new role through formal training and mentoring. Set the successor to work across different areas of the company so that they fully understand how the business operates.

If the company has been used to "store" family money as well as that earned through the operation of the business, the successor may want to separate out the family assets and distribute them to siblings before taking on the running of the business.

The successor will also have to ensure that the older generation extracts the right amount of the business on exit so that they have enough to live on without draining the company of cash and reserves.

Tax implications to consider

As with all exit options, passing your business to the next generation should be planned well in advance in order to take full advantage of any tax reliefs. There are a variety of tax reliefs that could be appropriate in these circumstances, including gifts relief, which provides a deferral from capital gains tax for transfers made below market value.

If you are substantially reducing your shareholding, there are circumstances where a purchase of own shares by the company may be appropriate. An example of this is when there are funds in the company and your successor already holds some shares. This can be treated in different ways for tax purposes and advice should be sought in advance.

Often, the generation exiting the business may wish to retain some element of control or flexibility over who succeeds to the business. For this reason, trust planning is often an important consideration in succession planning for family-owned businesses.

There may also be merit in retaining some share ownership while handing over management control. Shares in family businesses usually attract 100 per cent relief from inheritance tax, whereas cash on the sale of those same shares would be taxable in the estate on death.

In summary, there are many issues to consider in relation to tax and the family business. As ever, start the process early and take appropriate advice.

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) will all release the owner from the business relatively quickly and easily and are good options for businesses that have a management team who are committed to the long-term success of the business.

The principle for all three options is that the company is purchased by a management team – either the existing one (MBO), an external new one (MBI), or a combination of the existing team and an external senior manager (BIMBO).

Management Buy-out (MBO)

An 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*

- *It allows you to quickly realise value for the business you have created.*

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

- *There may not be a natural leader in the management team to follow the owner*
- *The management team cannot afford to buy the business without external funding*
- *It can be difficult to find an equitable selling price for the business – it is either too high for the management team (and saddles them with too much debt or too high a gearing) or too low for the shareholders.*

Businesses suitable for an MBO should have the following characteristics:

- *A strong track record*
- *Good growth potential*
- *Good cash flow*
- *Relatively low debt*
- *Good quality assets with a competitive advantage or unique selling proposition*
- *Not reliant on either one product or one customer*
- *Strong, diverse customer base*
- *Good relationships with customers and suppliers*
- *The potential continues to grow and be attractive to buyers, within a fairly short time frame, in particular if private equity investors are backing managment..*

Most MBOs involve high levels of both debt and equity finance and the need for both to be repaid needs to be considered from the outset. Debt finance providers will usually expect regular repayment over a five to 10 year period whereas those providing equity capital will be looking for a quicker return on their investment – probably from a company sale within a three to five year timescale.

Management Buy-in (MBI)

An MBI is similar except that an external management team 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.

An MBI requires similar financial backing to that required by an MBO but, not surprisingly, many institutions view them as more risky.

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 an MBO but MBIs 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.*

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” and an analysis of the company to ensure that it meets the characteristics listed above.

Once this has been achieved, the company needs to be valued and all parties need to be reassured that the financial structure of the company matches its profile (assets and income).

Beyond the financial obligations, the legal issues may include such things as staff protection against redundancy, issues relating to existing or contingent liabilities or potential litigation, and any issues relating to company pension schemes.

> ***PKF top tip***
> We always 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.

Buy-in Management Buy-out (BIMBO)

This option is a hybrid of an MBO and MBI and combines the knowledge of the existing team with the additional expertise of a person from outside the company 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, an MBO will be more appropriate.

Tax implications to consider

The tax implications for the vendor are usually relatively straightforward in an MBO, MBI or BIMBO because the shareholder is making a clean exit. The tax issues arising are similar to those identified in chapter 4 above.

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

Chapter seven

Exit route 4: Flotation

Although going public is often referred to as an exit route, the reality is that flotation is not an exit in itself, only a means to an end. 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 source of finance for funding an eventual exit, we have included it in this booklet.

PKF usually advises that a flotation may be an appropriate exit route for investors but is not usually the best route for an owner or majority shareholder.

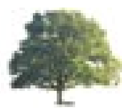
Flotation is also only really an option if the business is sufficiently large because a great deal of planning is required to make the most of such an opportunity and the advisory costs can be very high for an SME to bear.

In very broad outline, these are the main benefits and drawbacks of floating a company.

The benefits of flotation

- **Access to capital**
  As a public company you will be able to raise finance at the time of flotation and have greater access to capital in the future.

- **Cash out**
  Flotation may provide an opportunity for existing shareholders to realise part of their investment. However, this depends upon individual cases and market conditions. A flotation must not be seen as an exit route of key directors.



- **A market for the company's shares**
Floating your company creates a public market in which shares are readily tradable, enabling shareholders to realise the value of their holdings or to use stock to secure personal loans.

- **A higher public profile**
During and after the float, your company will be very much in the public eye and 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 and this, together with the regulatory and due diligence check necessary to come to market, will reassure both customers and suppliers.

- **Incentivised employees**
Many companies offer their employees profit-related bonuses or shares in the company as an incentive to participate in its continued success.

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 company is relatively small. A company can expect to pay up to £500,000 in professional fees for a flotation.

- **Investment of time**
Floating a company takes up a substantial amount of senior management time so it's all too easy to neglect the company that you are trying to float.

- **Loss of privacy**
Your company will find itself increasingly in the spotlight and, as a public company, you will be required to make detailed disclosures.

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

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 is trying to leave the stage.

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 and City 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.

For more detailed information on how to float your company, visit the PKF website at www.pkf.co.uk and register for a copy of the booklet *'Going public – a guide to whether, where and how to float your company.'*

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.

For example, 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. Also, 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.

An MVL can be also be useful in non-exit scenarios such as a reorganisation to facilitate the transfer of a business or assets to a new company without incurring Capital Gains Tax liabilities for either the company or shareholders.

How does an MVL work?

To wind-up a solvent company, the directors have to swear a declaration of solvency stating that they can and will pay all creditors within 12 months. This declaration is followed within five weeks by a meeting of the shareholders (members) to adopt a resolution to wind-up the company. This effectively places the company in Members Voluntary Liquidation. A liquidator is then appointed to realise all the assets and to distribute funds within 12 months of the start of the MVL.

PKF top tip

If you have decided that the business is going to come to an end when you retire, you need to ensure that, when the time comes, you collect all the monies owed to you and realise the value of all your business assets as these 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 an MVL, these are some of the issues to consider:

- *Professional adviser – an 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 that could rank for payment in a liquidation. 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*
  - *Funding of pension schemes*
  - *Employment liabilities*
  - *Guarantees given by the company, e.g. in respect of group banking obligations, or warranties in respect of goods or services supplied*

- *Indemnity – depending on the circumstances; the proposed liquidator may require an indemnity from shareholders or other group companies, particularly where there is an urgent need for an early distribution.*

Tax implications to consider

The cessation of trade will trigger the end of a chargeable accounting period and your corporation tax liability will fall due nine months and one day afterwards. You should take full advantage of the carry-back facility for any losses arising in the final period. You should also ensure that you make full provision for all your trading expenses as expenses post-cessation can only be offset against post-cessation receipts.

Remember that any expenses incurred in connection with cessation will not generally be allowable although statutory redundancy and contractual severance payments will be allowable.

Be careful about the timing of any pre-liquidation distributions. This is because any payments made by the company in advance of the liquidation may be treated as an income distribution in the hands of the individual.

Company payments to an individual shareholder during a liquidation are treated as full or part disposal for the purposes of CGT and the timing of the liquidation payments determine whether CGT will be payable. Make sure that you take advice about the availability of taper relief.

Chapter nine

Exit route 6: Innovative solutions

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

Partial exit

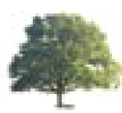
A partial exit is an option if you have a strong business that is attractive to investment groups or venture capitalists, and you also want to release some cash now but stay in the business until it has reached the next level of growth and profitability. It could be called the "some cake now but plenty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

Venture capitalists are increasingly happy to look at the partial exit option – which is effectively an MBO where the owner stays on as part of the management team. For example, if your business is worth £5 million, you could raise £2 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 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.

International entrant

The second option is to find an overseas company that is looking to enter the European 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 European marketplace for sales and distribution of their products and services.

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

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

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 gains tax liability 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.

Often "out of the box" options involve setting up a new company to take over yours, which can then provide leverage to finance the purchase. Care needs to be taken in these scenarios because there is anti-avoidance legislation which may mean that what you think you are receiving as a capital gain is actually an income receipt for tax purposes.

Chapter ten

Business and family wealth preservation planning

Making a controlled exit from a business should involve 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 and protection of your capital wealth and income built in to the transition.

For many individuals and families, the protection of their hard-earned estate from the attention of the H M Revenue & Customs is of great importance. To achieve this, you should work with an Independent Financial Adviser (IFA) to review the options for achieving the maximum retention of your assets after exit – and start early. The received wisdom is that you should start preparing at least two or three years before your actual business exit, especially if you have been extracting profits by way of dividends rather than salary to save on National Insurance Contributions.

Together you should consider the following planning issues:

- *Review of your existing pension arrangements*
- *The use of tax-efficient investment schemes*
- *Investment portfolio management*

- *Estate planning*

- *Using trusts to protect assets.*

Existing pension arrangements

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

The amount that the company can contribute to a pension on your behalf will depend on a number of factors including:

- *Your age*

- *Marital status*

- *How long you have been "employed" by your company*

- *Your salary history (excluding dividends)*

- *Any existing pension arrangements/benefits you may have.*

The answers to the above questions will dictate the pension regime most appropriate to your circumstances and thus the level of contribution that can be paid.

In addition, new legislation intended to simplify the complex pension regime will be introduced in April 2006. This will allow higher contributions to be paid than are currently allowed. Therefore, if you are approaching retirement, you should seek advice on whether it could be advantageous to delay your retirement date until the new regime is in place.

Key changes to the pensions regime for 2006/07

- New regime will replace the eight existing schemes with just three schemes
- Annual contributions of up to £215,000 per individual will qualify for tax relief
- The lifetime allowance will be extended to a total value of £1.5 million
- The limit of any tax-free lump sum will be 25 per cent

If you want to increase the level of your pension contributions, it is worth remembering that it is possible for a company to borrow in order to make pension contributions, although this may make it less attractive to a purchaser.

Currently, it is usually possible for your company to be allowed a tax deduction in respect of the pension contributions that it makes for employees. However, under the new rules from 2006/07, the company must prove that any contributions made are wholly and exclusively for the purposes of the business.

If the disposal of your company is handled through sales of individual company assets, it may be possible to offset any additional tax charge on gains or balancing capital allowances with deductions for large pension contributions. This may be particularly efficient from 2006/07 when the new pensions regime will allow your pension fund to enter into purchase transactions with members or related companies.

Retirement income

The amount of your pension will, obviously, depend on the amount in your pension fund.

Traditionally, having taken the maximum tax-free cash, the balance in the pension fund would be used to purchase an annuity with the pension income depending on the type of annuity chosen (e.g. flat rate or increasing with inflation). However, the introduction of flexible pension benefits has made annuity purchase much less attractive.

The Income Drawdown and Phased Income Drawdown options allow you to decide on the level of income that you would like to take, subject to the overall minimum and maximum amounts laid down by the Government Actuary's Department (GAD). This flexibility allows you to phase in your pension benefits, taking into account your personal circumstances and any other income streams you may have. This includes any continuing income from either the same or different employment.

It is worth remembering that, for most pension schemes, it is currently possible to start drawing your pension benefits from age 50, although the minimum qualifying age rises to 55 from 2010.

Again, it is essential to seek advice as there are risks associated with the flexible benefit regime that must be understood before opting for this route. In addition, if you start taking pension benefits and continue to receive income from the employment that funded your pension scheme, your tax-free cash may be taxed, unless certain procedures are adhered to.

It is important to balance the investment of your pension fund against the other assets you own and the income they produce. Depending on the exit strategy you have chosen, you may be able to retain income from the business property, shares in the company or other investments in the purchasing company. However, spreading the risk of your investments is vital and you should take detailed advice from an Independent Financial Adviser.

You can find out more about pensions planning and the new pensions regime that starts in 2006/07 on our website at www.pensionsreform.co.uk.

Final salary scheme – are you one of the lucky ones?

The traditional final salary scheme is aimed at providing its members with an income equivalent to two thirds of their final salary when they retire, in most cases after 40 years of service. However, the proportion of the current working population in the UK who will be able to retire on this maximum two thirds of their pre-retirement income is less than two per cent.

For the remaining 98 per cent of the population, the only certainty is that our income in retirement is likely to be less than two thirds of our working income and less than the amount anticipated when the pension schemes were originally set up.

It is unwise to place too great an emphasis on the perceived value of one's business to be able to make up any shortfall in pension income as it may not happen.

Therefore, regardless of any existing retirement planning already in place, PKF's financial planning specialists carry out a review of the type of arrangements that may exist in the average SME or "closely held" company. These are likely to include any or all of the following:

- *Small Self Administered Scheme (SSAS)*
- *Executive Pension Plan (EPP)*
- *Self Invested Personal Pension (SIPP)*
- *Group Money Purchase Scheme*
- *Final Salary Scheme*
- *Personal Pension Plan (PPP)*
- *Stakeholder Pension Plan*
- *Retirement Annuity Contract*
- *Funded Unapproved Retirement Benefit Scheme (FURBS).*

The use of tax-efficient investment schemes

With low deposit rates and the anticipation of lower equity growth than we have become accustomed to, it is important to ensure that the management of investment portfolios is focused on building capital growth or generating income. Ensuring that a portfolio is tax-efficient is vital although funds should only be committed for sound investment reasons and not for tax benefits alone.

Each of the following may have a place in a portfolio but professional advice must be sought to ensure that the underlying investment is matched to the investment goal, falls within an acceptable risk profile, and does not swap one form of taxation for another:

- *Individual Savings Accounts*
- *Venture Capital Trusts*

- *Enterprise Investment Schemes*
- *Offshore Investment.*

These four are the most common vehicles for developing a tax-efficient portfolio, but remember that tax efficiency will count for little without understanding the investment objective and attitude to risk that should dictate the investment strategy. In order to build a workable, flexible, effective long-term strategy, you must seek appropriate professional advice.

Investment portfolio management

This is traditionally regarded as a service provided by stockbrokers who administer and trade a range of equity, gilt, bond and cash holdings within parameters set by the investor.

While these holdings may still form the core of a client's investments, they should not be viewed separately from wider-based assets that may incorporate property and collective investments (bonds and unit trusts). You may use a specialist to handle individual elements of your invested assets but they must be considered together to ensure that a global view is taken and that correct weighting is given to reach the stated investment criteria.

Clearly, deposit rates, equity markets and, possibly, personal objectives are in a constant state of flux and ongoing monitoring is crucial. Although we would not seek to advise on the global situation, we can arrange professional stockbroking and other services that include:

- *Discretionary facilities*
- *Execution only*
- *Advice and dealing*
- *Share exchange facility*
- *CGT valuation*
- *Regular valuations and reports*

- *Full tax reports at year end*
- *Negating or, at least, mitigating the potential inheritance tax liabilities*
- *Ensuring that an acceptable lifestyle is maintained before assets pass to nominated beneficiaries.*

Estate planning

Generally speaking, the best solution is usually a simple one. Having said this, a degree of complexity is often unavoidable and the strategy might involve a combination of the following measures:

- *Exempt transfers*
- *Potentially exempt transfers*
- *Inheritance tax reliefs*
- *Making provision for the liability.*

Inheritance tax is often seen as a voluntary tax and much can be done to ensure that hard-earned assets pass to nominated beneficiaries rather than the Inland Revenue. It is a sobering thought that HMRC would be the major beneficiary of an estate valued at £1 million in 2005/06 that passes equally to three children. The Revenue would benefit to the tune of £290,000 while each of the children would only receive £236,666.

Using trusts

Although trusts are often thought of as elaborate arrangements only relevant to the extremely wealthy, they are really quite straightforward and simple, with one of the most effective being a Discretionary Will Trust. A Discretionary Will Trust can be incorporated within your Will and will not be activated until your death. The trust is designed to ensure that you utilise your nil-rate band exemption without any surviving spouse losing the ability to access the assets that form the trust.

The use of trusts in financial planning is becoming more common, particularly in the field of estate planning, and this is no doubt due to the growing affluence of much of the population.

There is an answer to every inheritance tax situation but it does take time and effort to find the solution.

Glossary

Here is a glossary of some terms used in this booklet.

Balancing charges

Withdrawal of some or all of the capital allowances previously given. They arise when fixed assets stop being used in your business. Balancing charges may be made on the general capital allowances pool if the proceeds of sale of pooled assets exceed the tax written down value of the whole pool.

Buy-in Management Buy-out (BIMBO)

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

Close investment company

A company which is controlled by five or fewer shareholders, treating any separate shareholders from the same immediate family as though they were one shareholder. The majority of private companies are “close”. Ask the company auditors for confirmation if you are not sure.

Due diligence

The process of investigation, performed by investors, into the details of a potential investment, such as an examination of operations and management, indentification of liabilities and the verification of material facts.

Enterprise Investment Scheme (EIS)

A tax-advantaged scheme which enables individuals investing in the shares of certain small trading companies to get income tax relief at 20 per cent on the funds invested and exemption from tax on gains made on disosal of the shares. Capital gains made on other assets can be

rolled over by those investing in EIS: the original gain becomes chargeable when the EIS shares are disposed of or cease to qualify. There are strict rules on companies and individuals who qualify and on the amounts that can be invested by one individual.

Executive Pension Plan (EPP)

This is a Defined Contribution Occupational Pension Scheme. The maximum contributions that can be paid are based on the age of employee, length of service with the employing company and the salary. Pension contributions can be significantly higher than under a Personal Pension Plan. Particularly as the rules allow for back service to be funded. The maximum benefits that can be taken from an HMRC approved pension scheme are limited by the tax rules as is the size of the accumulated fund.

Exempt transfers

Transfers that are not subject to inheritance tax.

Final Salary Scheme

Benefits are calculated on the length of service with the employer and the salary. Based on these two factors and the accrual rate within the scheme, pension benefits are guaranteed, regardless of movement in the underlying fund or changing annuity rates.

Funded Unapproved Retirement Benefit Scheme (FURBS)

Unapproved pension schemes, or Funded Unapproved Retirement Benefit Schemes (FURBS), are occupational schemes that build up retirement benefits in excess of those allowed under approved pension schemes.

Employers typically set them up to provide more flexible remuneration packages for high earners who would be restricted by the earning cap and for those with less than 20 years service. Such schemes do not receive the generous tax reliefs available to approved pension schemes.

GAD

The United Kingdom Government Actuary’s Department (GAD) is a unique organisation – a government department and yet an actuarial consultancy operating on commercial lines giving independent professional advice within the public service. There are actuaries in public sector roles in many countries, but in few places are there such strong concentrations of actuaries who advise on such a comprehensive range of topics.

Group Money Purchase Scheme

A company scheme governed by the same rules as an Executive Pension Plan.

Heads of Terms

Heads of terms (sometimes called term sheets, letters of intent or memoranda of understanding) set out the agreement in principle between parties, and are usually not intended to be legally binding (although they can have legal consequences and need to be drafted with care).

Management Buy-out (MBO)

The purchase of a company by the management team that already runs the business.

Management Buy-in (MBI)

An MBI is similar to an MBO except that an external management team purchases the company.

Personal Pension Plan (PPP)

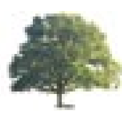
A pension scheme under which contributions are limited to a percentage of salary. The maximum contributions are as follows:

Up to 5 April 2006			2006/07	2007/08	2008/09
Age at start of year	**% Contribution**				
Up to 35	17.5	*All ages 100% up to*	£215,000	£225,000	£235,000
45-45	20.0				
46-50	25.0				
51-55	30.0				
56-60	35.0				
61 & Over	40.0				

The salary used in the calculation will be restricted by the Earnings Cap (£105,000) for 2005/06.

Potential Exempt Transfers

Outright gifts that fall outwith a person's estate after seven years.



Self Invested Personal Pension (SIPP)

A Personal Pension that allows an individual to “self invest” the fund into any of a number of investments as proscribed by the Inland Revenue.

Small Self Administered Scheme (SSAS)

An Executive Pension Plan that allows the Trustees greater investment control. Investment options allowable include commercial property and loans to the employer.

Stakeholder Pension Plan

A Personal Pension Plan under which the only charge is a 1% Annual Management Charge.

Taper relief

The exemption from capital gains tax of a proportion of each chargeable gain arising to individuals. The size of that proportion depends on the length of time the asset has been owned and whether or not it qualifies as a business asset throughout its ownership or the last ten years.

Business asset taper relief is currently at 75 per cent for assets owned for more than two years, which means only 25 per cent of capital gains arising on their sale is taxable (or an effective 10 per cent rate of tax for a higher rate taxpayer suffering 40 per cent tax). Non-business asset taper relief accumulates more slowly and therefore exempts only a smaller proportion of the gain from tax. The detailed rules concerning taper relief are complex and advice should always be sought from your tax adviser.

Source of information

General

PKF's website – advice and business sales	www.pkf.co.uk
Family business and advice	www.family-business-experts.com
DTI Small Business Service	www.sbs.gov.uk
Exit planning	www.businesseurope.com/startup_and_exit/sub_sections/exit_planning

Pensions

PKF's pensions reform website	www.pensionsreform.co.uk
Financial Services Authority	www.fsa.gov.uk/consumer
FSA pension calculator	www.pensioncalculator.org.uk
Department of Work and Pensions – state pensions information	www.thepensionservice.org.uk

Retirement

Business Link – retirement info	www.businesslink.gov.uk/bdotg/action/layer?topicId=1074453583
Retirement info	www.agepositive.gov.uk www.over50.gov.uk/ www.pra.uk.com/ www.laterlife.co.uk www.experiencecorps.co.uk/xq/ASP/id_Content.634/id_Page_Parent.50/qx/article.htm

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