# Turning disaster into success

... how to acquire a business that's failed

*Expert knowledge means success*

**Contents**

**Note:** This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

# Introduction

In difficult economic times when many businesses fail, bad management is singled out as the main reason for their demise.

Strong businesses with good asset backing and resources can become stronger in a recession because they are able to buy other businesses that are in trouble. There needs to be a good reason for making an acquisition of a business that's in trouble - often such a business has a good core to it and could be profitable if it was rid of its burden of debt and if it had better management. Integrating such a business with a successful operation can make both stronger. Handled badly however, the acquiring company might bite off more than it can chew.

This publication provides guidance to acquisitive businesses and owners, focussing first on acquisitions generally and then moving on to the special factors applicable to targets that either are in or have been in some financial or other difficulty.

# Acquisition Checklist

We live in turbulent economic times. Everything seems to move so quickly in business today. Even in good economic conditions, it's an established fact that more than fifty percent of all acquisitions fails.

It's difficult to be precise as to the reason for such a high failure rate. It's likely that the main reason is that the predator company fails to devote enough time and resources in a strategy for the search and acquisition of its target businesses as well as the integration of the acquired business with existing businesses.

When we say that more than half of all acquisitions fail, it doesn't necessarily mean that the failure was a complete corporate and financial disaster followed by liquidation - what happens more often than not is that there is a failure of actual achievement measured against expectations prior to the acquisition being made.

# Putting your acquisition plans together

It's important that the approach to acquisitions is conducted on the basis of a coordinated approach and that it's part of a well-thought out plan. Acquisitions made on an ad-hoc basis will, more often than not, result in disaster.

The acquisition programme should include:

- the setting of acquisition criteria (price, industry sector and the likely profile of target businesses);
- strategic review of the existing business (and the opportunities to integrate new businesses into it);
- research and search (as to what is available in the market place);
- procedure for shortlisting and reviewing information;
- agreeing an investigation, appraisal and evaluation procedure;
- agreeing the method of approach to prospective target businesses;
- setting procedures (to cope with the integration of the new business after its acquisition).

# Businesses in trouble - what to look for

The following are indications of a business that is failing with the probable causes of failure noted alongside:

- **Management problems** – either lack of experience or lack of cohesiveness in management. Sometimes lack of skills and an unwillingness to cope with the obvious;

- **Financial management out of control** – financial information such as accounts are not available, breakdown in accounting systems, poor credit control or even failure to recognise all the financial warning signs;
- **Other causes** – increased competition, high cost structure, changes in market demand, adverse movement in commodity prices, lack of any coordinated marketing effort, badly planned diversification or acquisitions and overtrading.

The symptoms of organisational decline include:

- Decrease in profitability;
- Decreasing sales column (sales per employee, sales per square foot etc.);
- Increase in debt evidenced by a rise in the level of gearing;
- Decrease in liquidity measured by current acid-test ratios and by inventory, debtor and creditor situations;
- Dividend policy where a reduction indicates the need to conserve cash;
- Delays in publishing accounts or use of generally unacceptable accounting policies are often symptoms of decline;
- High turnover of management indicating top level disagreements;
- Management fear, leading to effective incapacitation;
- Declining market share due to ineffective competitive strategy;
- Lack of strategic thinking.

## Back to the Beginning?

If a company disposes of its assets and its business prior to its formal insolvency (liquidation or receivership), at a later date the sale could be overturned by a liquidator or administrator – if the transaction is treated as one having taken place at an undervalue, a subsequently appointed liquidator or administrator will have to prove two things:

- The price actually paid for the business and its assets was significantly less than they were actually worth;
- At the time the transaction took place, the Company was insolvent (unable to pay it's debts as and when they fell due) or that the Company became unable to pay it's debts as a consequence of the transaction itself.

To ensure that the purchaser is not subsequently faced with a long drawn out agreement with an insolvency practitioner, it is often appropriate to allow the business to be placed into formal insolvency, and for the transaction to be effected as between the purchaser and the liquidator or administrator as the case may be.

## Information Required

Prior to the acquisition of the share capital of a company, the purchaser will need some preliminary information about the business to be acquired.

We have published a number of checklists covering the items that, in most situations, are required. However these are merely illustrative and may not apply in every instance nor may they be complete - check with us to find out which checklist best suits your own circumstances.

## Due Diligence

Due Diligence has many meanings - call us for our publications on this subject:
275-Due Diligence-Strategic Issues
703-Key Issues in Legal Due Diligence

Due Diligence is the process whereby the parties to an acquisition assess the risks they are taking.

Risk itself has many interpretations. In Russia there is an old saying: *"If you don't take risk, you don't drink champagne"*. By way of contrast, American General George Patton, who acquired something of a 'gung-ho' reputation, was actually more prosaic, saying, *"Take calculated risks - that is quite different from being rash"*.

For the purchaser and his financiers, a range of risks exist, such as:

- The political risk associated with the countries in which the Target is based;
- The accuracy of the past financial accounts of the Target;
- Whether the Target's key personnel, suppliers and customers will remain;
- Whether the Target has good title to its assets;

- Whether those assets are worth the value the Target attributes to them;
- Whether there are any existing liabilities that may manifest themselves in the future to disrupt the operation or financial performance of the Target.

One or both of the parties will carry these risks, some properly being the sole responsibility of the purchaser to assess - for example political risk. Others are conventionally considered the responsibility of the vendor, for example the accuracy of the past financial accounts. However, once identified, the majority of the risks are negotiable and the bargaining between a vendor and a purchaser will relate predominantly to the apportionment of these risks between them.

In conducting those negotiations, the purchaser is at a disadvantage since he does not have the data to identify and assess those risks accurately. Accordingly, one of the most important decisions that every purchaser has to make at the earliest stage of any transaction is the degree to which he wishes to redress the knowledge imbalance between himself and the vendor. Conversely, unless the vendor conducts his own Due Diligence in advance of selling the business, it is possible that the well-advised purchaser will eventually achieve information superiority over him.

## Assumption of liabilities and obligations

Often, a purchaser has to take on many of the obligations of the vendor in relation to the business - such as the assignment of leasing and other contracts, assumption of liability for redundancy under the Transfer of Employment legislation and obligations under property leases and pension commitments. It's absolutely crucial for the purchaser of a business, particularly in relation to a business that's been in some financial difficulty, to gather as much information about the business as may be possible. The Due Diligence process is designed to flush out the "skeletons in the cupboard" that may exist.

## Warranties and Indemnities

The purchaser will wish to check that:

- The assets have the value the vendor is giving them;
- The vendor has good title to those assets;
- There are no risks that reduce the value or use of those assets, e.g. another party having a right to use them;
- There are no other hidden or undisclosed liabilities that may adversely affect the Target, e.g. taxation liabilities.

Although the vendor may provide warranties that give assurances on these issues, the purchaser will nevertheless wish to check them. This is not dissimilar from the ‘Trust but Verify’ attitude adopted by the Soviet Union during the Strategic Arms Limitation Talks with the United States in the 1980s.

The verification approach also reduces the potential for conflict because problems are identified early on. All too often, the vendor is not even aware of its own problems, until the purchaser discovers them during Due Diligence.

Purchasers also recognise that warranties and indemnities given by vendors:

- Last only for a few years;
- Are limited by amount;
- Can be disputed;
- Can be difficult to enforce.

A warranty or indemnity claim is something that every vendor dreads. Having already endured the highly stressful experience of selling a business and having possibly already re-invested the sale proceeds, the last thing the vendor wants is to have to lock horns with the purchaser again in a protracted and expensive legal dispute over warranties. The problem is that if a vendor is not prepared or cannot, for whatever reason, give warranties he will have to accept a significant diminution in the purchase price. Putting warranty insurance in place, to cover against possible future claims, may provide vendors with a solution to this problem.

Warranty insurance is a relatively recent phenomenon. Indeed, there are only a few brokers who specialise in this area, and advisers tend to dismiss the concept as either "too expensive" or "too complicated." In certain circumstances, this conclusion may be correct. However, from our experience, whilst many professional advisors have heard of the concept, few have investigated it in any detail, and even fewer have had direct experience of applying it in practice - check with us for details and also for a copy of our publication on this subject:
265-Warranty Insurance

# Further Information

This publication is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

## Important Notice



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