

Acquiring a Recruitment Business – What are the Options?

Many people speak of making acquisitions but in reality, only a very small proportion of businesses ever complete one. There may be a variety of reasons for this including:

- A lack of understanding of how acquisitions work
- Thinking that only substantial businesses can afford acquisitions
- Not knowing where to start

This paper is aimed at demystifying acquisitions to help you consider whether an acquisition strategy could be beneficial for your business.

Reasons for Considering an Acquisition

It is always important to have a sound commercial reason for an acquisition, which might include:

- Geographic expansion
- Diversification into a new or associated sector
- Acquiring new customers
- Eliminating a competitor
- Securing presence on a contract or framework agreement
- Utilisation of cash reserves

This list is not designed to be exhaustive but includes a number of the most common reasons for acquisitions.

In each case the underlying rationale is to increase profitability and the value of the enlarged business.

Performance of an Acquisition Target

Targets can be at various stages of their lifecycle and performing in a variety of ways. There can be strong commercial justification for acquiring a business at any of these stages, depending upon the circumstances of the acquirer.

- a) A distressed business may be in need of rescuing. Recruitment businesses in this position often won't approach potential acquirers but may seek professional advice, typically from an Insolvency Practitioner. Businesses which can be acquired in this way are likely to be cheap assets and whilst risky, can provide a quick payback on investment. It is generally hard to find distressed opportunities and many businesses would like the opportunity to make such an acquisition, so basing an acquisition strategy purely on finding this type of opportunity will not have a high prospect of success.
- b) A business where performance has reached a plateau is likely to command a modest price in relation to a growing business. Nevertheless there can be value in acquisitions of this nature, typically where the acquirer can breathe new life into the business, energise the team and enhance profitability. There may also be cost saving opportunities, but this should never be

the sole justification for making an acquisition as such savings are notoriously hard to deliver. There are risks in deals of this nature, for example there is no guarantee that staff will welcome the changes in working practices. The acquirer should seek to meet key employees during the acquisition process, but a vendor is likely to resist this for as long as possible for fear of unsettling their team.

- c) A growing business is likely to attract interest from a number of potential acquirers. Inheriting a successful business rather than one requiring changes is likely to be a safer transaction, although more expensive. It is important that the acquirer believes they can achieve a return on their investment and they should therefore be able to see how future growth will be delivered.

Deal Structure

Structuring an acquisition is a crucial aspect of making a transaction successful. It is a complex area and each transaction will have its own specific features. There is no simple template for structuring a deal and much will depend on negotiation.

- a) One crucial aspect is whether the acquirer buys the shares in the target company or its business and assets. Acquiring shares means that **all** assets and liabilities pass to the acquirer, whether identified or not, whereas under an asset deal only the **specified** assets and liabilities transfer to the acquirer. A share deal therefore requires more detailed due diligence. There are many other distinctions on which advice should be sought before a decision is taken on deal structure. Vendors generally prefer share sales, particularly as this makes it easier to enjoy the benefit of Entrepreneur's Relief which means Capital Gains Tax is payable at 10% under the current tax regime on gains of up to £10m per person.
- b) Set out below are the most common components of a recruitment acquisition structure:
 - i. Cash on completion – vendors generally want to maximise the value they receive in cash on completion as there is no risk associated with this
 - ii. Deferred consideration – an agreed amount of consideration payable at a fixed date in the future. Deferred consideration cannot increase but can be scaled back if performance criteria are not met
 - iii. Earnout – Consideration payable in the future dependent upon performance of the business. Typically this is used to top up initial consideration if the acquired business performs strongly post acquisition and target, particularly if vendors claim that the business is poised for growth. This is a complex mechanism which requires careful structuring to ensure all parties desire the same outcome, otherwise an earnout can give rise to conflicts and can destroy value
 - iv. Equity – whilst public companies like to use their shares as part of the purchase consideration, private companies can also employ this strategy. A successful business building towards an acquisition which makes acquisitions can offer shares to vendors who are staying with the business to help to deliver further growth. This offers them the opportunity to participate in a more substantial ultimate exit and further enhance the value received for their business. Their risk is becoming a

minority shareholder in a private company, so it isn't always regarded as an attractive option.

- c) Ensuring that an acquired business has a suitable level of working capital is a final but essential ingredient in deal structuring. This is a complex area which will be the subject of negotiation as there is no standard formula and the treatment of debt, including factoring or invoice discounting, is a hotly debated topic.

Funding Options

Funding can be a major consideration when exploring acquisitions and each acquirer will have its own funding structure, trading profile and cash reserves. It is impossible therefore to offer specific advice or guidance on how acquisitions should be funded. However below are typical ways in which acquisitions are funded, which are closely linked to deal structure matters covered above:

- Use of own cash reserves
- Raising funds from own debtor book
- Raising funds from target's debtor book
- Bank loan based on future profits ("cashflow loan")
- Deferred consideration or earnout to be paid out of future cashflow of the business
- Raising equity finance out of which proceeds can be used to fund an acquisition
- Utilising own shares as part of the consideration

Part of the decision on funding will be determined by an acquirer's attitude to debt. Opposite ends of the spectrum are:

- a) Maximise debt within the business (within affordability parameters) in order to maximise the level of equity held in the business
- b) Avoid debt in the business and share equity, which avoids financial and mental stress but may dilute future value

Neither of these is "right" or "wrong" and personal preference and business philosophy will play a big part in making this decision.

Finding Acquisition Targets

Whilst all of the matters covered above are essential ingredients of making a successful acquisition, they are redundant unless one or more suitable targets are found.

There are many options as to how this should be approached. Below is some guidance based on our experience:

- Establish key criteria at the outset and **stick to them**. Compromising can lead you off track
- Don't rely on finding distressed opportunities
- Consider business which are on the market for sale, but recognise that:
 - They may not be your ideal target
 - You will be part of a competitive process
 - You cannot control the process

- The most effective way of identifying a range of targets to evaluate and controlling the process is to approach off-market targets which offer a strategic fit
- Off-market targets may not be ready to sell, even if they would be an ideal acquisition target
- Targets are more likely to be responsive to an advisor than a recruiter approaching them, who they will regard as a competitor
- Using an advisor to make approaches gives a sense of professionalism and seriousness
- Establish price expectations early as an approached business may be flattered and expect an inflated valuation to persuade them to sell

Final Observations

In addition to the topics covered above, we always advise acquisitive clients to adhere to these rules:

- Stick to your criteria and don't be drawn to a target which doesn't fit with your strategy
- Be prepared to walk away if price expectations become unrealistic
- Don't overstretch financially to complete an acquisition
- Expect deals to take longer and for savings to be harder to achieve than hoped
- Don't take your eye off the ball and allow your business to slip during the process

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