OPTIMA CORPORATE FINANCE

Selling a Recruitment Business

Introduction

Recruitment businesses are set up for a variety of reasons, often because the founders no longer want to work for someone else and feel they can do a better job than their current employer of looking after clients.

Whilst some business owners set out with the specific aim of building a business in order to sell it, the majority are initially more focused on service delivery and earning income. Selling the business only becomes a consideration some years later.

Whenever an owner decides they want to sell their business, there are many factors to consider in order to achieve the maximum value. Planning is required for some while in advance of the actual sale and failure to plan will undoubtedly impact on the price achieved for the business.

The first decision to be made is when does the owner want to sell the business and why. An acquirer will want to know the reason for the sale and if this does not seem credible, they will immediately be suspicious. No acquirer will want to feel that either:

a) An owner isn't really serious about selling but just wants to test the market. The acquirer will not spend time with an owner giving that impression; or

b) An owner doesn't have any future plans and within 6 months is likely to want to set up in competition. Although there will be contractual restrictions, no acquirer would want to buy a business if they had a concern that this might be the case.

Having determined when the owner wishes to sell the business, they should then consider the matters which an acquirer will consider when reviewing their business.

What does an acquirer look for?

There is no "perfect" model of what an acquirer will look for in an acquisition target and different acquirers will have their own preferences. For example, some acquirers only want to buy distressed businesses which they can turn around, whilst others will want strong businesses with a proven track record.

As business owners generally aim to build the best business possible, this brief focuses on how to achieve that from an acquirer's perspective. It should be noted that these are general guidelines and there are exceptions to every rule.

Specialism

Businesses are regarded as more valuable if they specialise in one or more particular areas. This can either take the form of a broad vertical market (e.g. food) or a more specialist niche market (e.g. on site bakeries). In either case, the specialist knowledge of the selected market will be

attractive to the right acquirer, more so than a business making the same profit with a scattergun approach which does not provided a sound basis for sustainable growth.

Branding

Coupled with having a specialism is the branding of the business. Having a recognisable name and good quality reputation in a selected market will make a business more attractive to an acquirer. An acquirer has to justify paying to buy a business rather than starting up a new venture, so inheriting a well-regarded brand in their selected market helps to justify making an acquisition.

Spread of Clients

A strong business will have a healthy spread of clients with no over-reliance on any individual client relationship. This can be a particular challenge for smaller business, especially in the early stages of building the business, but owners must recognise the risk that this poses. An acquirer will be nervous as to the sustainability of the business if it depends on a small number of key relationships.

Robust Client Relationships

An acquirer will prefer to see long term relationships with clients, demonstrating that clients value the service being provided, rather than numerous short term relationships which might produce the same financial performance but which would question the quality of the business.

Healthy Margins

An acquirer will look closely at the margins being achieved to ensure they are healthy, relative to the rest of the market in which the business operates. If business is won by undercutting competition, this will be regarded as low quality and providing a commodity rather than a valued service to clients.

Sustainable Margins

Equally, if a business is overcharging clients for their service, an acquirer will regard this as unsustainable in the medium term and will discount the current performance of the business to reflect this.

Client Contracts

Some acquirers like to see client contracts as a sign of commitment. Presence on PSLs is often regarded in the same way. But this is not a black and white issue as some acquirers regard contracted and PSL business as less valuable as margins are often lower, so non-contracted business can be more valuable if it is maintainable via long term relationships.

Compliance

Strong compliance procedures are a sign of a quality business and something which an acquirer will examine thoroughly when evaluating a business. Failure to adhere to GLA regulations or to operate non-compliant tax schemes for workers will deter many acquirers at the earliest stage of discussions as the business will be regarded as problematic and too risky to acquire.

Locations

There is nothing wrong with running a successful single site business and such a business could be perfectly sellable. However a business with multi locations offering its clients regional or national services may prove more attractive to certain acquirers. It is crucial that standards are maintained across all locations, otherwise this could detract from the value of a business.

Management

One of the crucial issues an acquirer will consider is the quality of management remaining with the business after they have acquired it. Shareholders who are intending to leave the business immediately or soon after the sale must ensure that the business is not dependent upon their ongoing involvement. In particular, key client relationships should reside with remaining managers, who should also have the knowledge and ability of how to run the business on a day to day basis.

Staff Loyalty

An acquirer will take comfort from longevity of service of key employees, as long as they can demonstrate good performance, whereas if a business consists mainly of relatively new employees, an acquirer will be less confident of the maintainable performance of the business. Incentive and share option schemes are common methods of attracting and retaining key employees, which are generally looked upon favourably by an acquirer.

Profitability

It is of course important that the business is profitable. Owners of private businesses often seek to depress reported profits in order to minimise tax liabilities, but it should be recognised that this can have a detrimental impact on the value of the business when it comes to selling. Although profit adjustments are acceptable where appropriate, consistently reported profits will be more attractive to an acquirer and are likely to increase the valuation of the business.

Investment

It is important to continue investing in the business leading up to a sale process. If the owners stop hiring staff, cut advertising and reduce expenditure in order to maximise profitability, an acquirer will identify this and will regard the short term measures taken as damaging to the business as well as an attempt to artificially boost the valuation of the business. In certain instances some measures may be acceptable but these need to be carefully considered.

To summarise all of the above in a single word, an acquirer will evaluate all of these areas from the perspective of **RISK**. In each instance the less risky the business is, the greater the price an acquirer will be willing to pay. No business is risk free, but the more measures an owner takes to mitigate the risks in their business for a new owner, the more attractive (and therefore valuable) their business will be.

The sale process

There is no definitive process which every sale follows and it is true to say that every deal has its own unique features and nuances.

One of the most common concerns when entering into a sale process is that staff will find out sooner than the owners intend about the sale, which might unsettle them and even cause them to leave. Equally, owners are often concerned that if a close competitor becomes aware of the proposed sale, they might take the opportunity to be mischievous with either staff or clients. Running a carefully controlled process is therefore crucial.

Some owners prefer their advisors to undertake a full marketing exercise to ensure that all potential acquirers are aware of the opportunity, with the added possibility of unknown acquirers also finding out and entering the process. Others however prefer to be far more discreet and will ask their advisors to approach a select number of hand-picked potential acquirers to see whether

any of them will make an acceptable offer. If not, a wider process can of course then be undertaken.

The various steps of a full process are summarised as follows:

Step 1 – Preparation of Documentation

- Preparation of Information Memorandum
- Preparation of an anonymous Executive Summary document which will briefly describe the opportunity, designed to enable potential purchasers to decide whether they wish to review the Information Memorandum
- Preparation of Non-Disclosure Agreements

Step 2 – Identify Potential Purchasers

- Research potential strategic purchasers
- Owners may wish to include any potential purchasers of which they are aware or with which they have an existing relationship
- Agree any parties not to approach

Step 3 – Issue Information

- Issue anonymous Executive Summary to potential acquirers
- Obtain signed NDAs
- Issue Information Memorandum to interested parties

Step 4 – Meet Interested Parties

- Arrange meetings with parties interested having reviewed the Information Memorandum
- Present the business to potential acquirers, focussing on key areas
- Supply additional information requested at or following initial meetings

Step 5 – Receive Indicative Offers, Further Meetings and Revised Offers

- Receive indicative offers from interested parties including key assumptions underlying their offers
- Prepare focus areas / objectives for follow-up meetings
- Arrange and attend follow up meetings
- Obtain revised offers
- Evaluate and prioritise offers
- Negotiate deal structure, including an earnout if appropriate
- Select preferred purchaser

Step 6 - Negotiate Heads of Agreement

- Attend further meeting with preferred purchaser if appropriate
- Produce draft Heads of Agreement
- Negotiate, finalise and sign Heads of Agreement
- Enter into period of exclusivity with preferred purchaser

Step 7 – Due Diligence and Contracts

- Draw up deal timetable to be agreed by all parties involved in the process
- Supply responses to information requests for due diligence using a Virtual Data Room
- Review draft contracts, warranties, due diligence findings and work closely with advisors throughout this phase of the Project

- Finalise contracts, negotiate final warranties and prepare Letter of Disclosure to protect owner against warranty claims for known items

Step 8 – Completion

- Completion of contracts concludes the deal process

Guideline Timetable

Steps	Task Details	Timetable
Step 1	Preparation of Documentation	Weeks 1 – 4
Step 2	Identify Potential Purchasers	Weeks 3 – 4
Step 3	Issue Information	Weeks 5 – 7
Step 4	Meet Interested Parties	Weeks 8 – 10
Step 5	Receive Indicative Offers, Further Meetings and Revised Offers	Weeks 10 – 16
Step 6	Negotiate Heads of Agreement	Weeks 17 – 18
Step 7	Due Diligence and Contracts	Weeks 19 – 25
Step 8	Completion	Week 26

Valuation

The central issue when considering selling a business is valuation – how much is the business worth?

There is no simple answer to that question but there are certain factors and parameters which can help to value a recruitment business. However as with every asset, a business is only truly worth what an acquirer is prepared to pay for it.

The key to maximising the valuation is therefore to be talking to the parties who will regard the business as most valuable as it offers a strategic value over and above the current performance. Examples of this might include:

- Adding new clients for the acquirer who can cross sell additional services
- Adding a new geographic region for the acquirer, which might enable them to broaden their offering to existing clients or tender for national contracts
- Presenting the acquirer with a licence or presence on a framework contract which can add value to their current business

Valuation Methodology

The most widely used method for valuing recruitment businesses is a multiple of EBIT or EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation).

If this method is adopted, an acquirer buying a business will pay the equity value, which is calculated as follows:

EBITDA x multiple = Enterprise Value + Cash – Debt = Equity Value

EBITDA

EBITDA is used to measure the maintainable profit which can be generated by a business (i.e. how much profit the business can continue to generate for the new owner), excluding variable

items such as interest and tax which can vary from one company to another depending upon their funding structures and rate of corporate tax they pay, which can vary depending upon size, past losses etc.

An EBITDA figure can include adjustments to the profit shown in the company's accounts to ensure it properly reflects maintainable profits. Examples of common adjustments are:

1. Directors' remuneration. Directors may pay themselves by dividend or salaries which are not in line with market rate (might be higher or lower). An adjustment would be made to ensure that the market rate cost of a person fulfilling the role carried out by an exiting shareholder is properly reflected

2. Directors may incur certain travel, entertaining or other costs which would not necessarily be recurring when the business is under new ownership. Suitable adjustments would be needed to reflect this

3. Other non-recurring costs can arise at any time, such as legal fees in the event of a dispute. These would be adjusted if they are one-off costs not expected to recur

Negotiation is sometimes required to agree which period the EBITDA should be taken for. It can be the last full year, the current financial year, an average or weighted average of the two or any other variation which might be agreed.

Multiple

Having established the EBITDA figure, the key question is what multiple to use. Every business is different and there is no scientific method of determining a suitable multiple. A business has different values to different people depending upon the value they can derive from it.

Below are a number of factors which will influence the multiple which is suitable for any business:

- Comparative plc multiples
- Size of the business
- Recent comparable deals
- Competitive tension between potential acquirers
- Strategic fit
- The perceived risk arising from the matters reviewed by the acquirer referred to in Section 2 above
- Market sentiment
- What the acquirer is willing to pay

The multiple will also be determined partly in relation to the deal structure adopted. If an owner wants an outright sale, this increases the risk to the purchaser which will therefore be reflected in the price paid, but acquiring the same business if the shareholders remain involved through an earnout for say 2 years after completion will give the purchaser greater comfort and they will therefore be prepared to ultimately pay more for the business.

Balance Sheet

As mentioned above, the equity value of a business takes into account cash and debt on the balance sheet. Purchasers are generally willing to allow vendors to take "excess" assets off the

balance sheet as part of a deal, but there is no agreed method for determining what constitutes excess assets.

Phrases used include surplus cash, cash-free, debt-free and normalised working capital and there are various ways of calculating each. Some acquirers regard factoring or invoice discounting as debt whereas others are willing to treat it as working capital, which can make the difference between a sensible valuation and one which is unrealistic from the vendors' perspective.

This area requires careful negotiation and professional advice during the deal process and in certain circumstances it is necessary to deal with it early in the sale process if the sums are material, to avoid wasting valuable time.

There are many additional areas to address before and during a sale process relating to deal structure, legal and tax issues. Professional advice should be sought to avoid the many pitfalls which can arise, potentially destroying value which has taken years to build.

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