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CORPORATE KNOW-HOW

BUYING A BUSINESS: STRUCTURING THE PURCHASE PRICE

HOW TO BUY A BUSINESS

STRUCTURING THE PURCHASE PRICE

When making an offer for a business, the question of when the consideration will be paid can often be just as important as how much will be paid. Even once initial terms are agreed, how and when value is transferred from the buyer to the seller can remain in flux over the course of a transaction as previously unknown risks come to light, or the latest financial results of the target are revealed.

While an acceptable headline offer for a business will kickstart negotiations, often heads of terms are non-binding, offering a frame of reference for the final deal terms rather than a guarantee of what they will be. This flexibility allows either party to revise what they are willing to offer or willing to accept as the transaction progresses and negotiating power shifts.

From a buyer's perspective, there are many ways to structure your purchase offer to mitigate risk, reduce cashflow pressure or incentivise any sellers remaining involved in the business post-sale – and sometimes all these aims at once.

In this article, we are going to look at four of the most common options available to prospective buyers (beyond upfront cash payments) and the risks/rewards posed by them.

(1) DEFERRED PAYMENTS/RETENTION

Arguably one of the most common ways of providing for unknown liabilities and easing cashflow pressure on a prospective buyer at the same time, is deferring a proportion of the purchase price for payment to the seller at a later date (often on an anniversary of the date the sale completed). Whether the amount deferred is an arbitrary percentage of the total purchase price or tied to estimated liabilities, deferring payment ensures funds can be kept readily available to meet the cost of a claim against the seller post-sale.

For a buyer without the resources immediately available to fully finance an acquisition, deferring a proportion of the purchase price can provide the opportunity to realise other assets or obtain additional funding without missing out on the opportunity the acquisition offers.

(2) EARN OUTS

Unlike a deferred payment, an earn out places the emphasis on the seller to either stand behind or actively contribute towards, the ongoing profitability of the business they have sold. The structure of earn out payments can be highly flexible – with relevant hurdles being directly linked to performance (by way of a percentage share of profits) or set as a fixed payment once a required target is met. If a business fails to meet the relevant target it can result in no further payment being due to the seller or even a partial refund of the purchase price paid so far.

Where a seller remains engaged in the business in some capacity, earn outs offer a low-risk way of incentivising their performance while ensuring that further payments are only made by the buyer where the business performs positively post-sale. They are one of the most commonly used tools to ensure that a buyer does not overpay for an asset.

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(3) LOAN NOTES

Although not appropriate to every transaction structure, loan notes can be issued by a buyer to a seller as evidence of (and a promise to pay) a debt that forms part of the purchase price. Similar to deferred payments, the issue of loan notes allows a buyer to spread the purchase price over a longer period, easing cashflow pressure and providing time for any seller liabilities to be revealed. Payment of the sum due under loan notes or their conversion into shares (where relevant) can be tied to specific dates or business milestones, permitting a significant amount of flexibility in how and when their value is realised for the seller.

Where convertible into shares, loan notes can be a valuable incentive for a seller to remain engaged in the business before a further funding round in the near future, which can often be a milestone upon which the loan notes convert into shares.

(4) CONSIDERATION SHARES

Although not necessarily appealing to a seller looking to retire or quickly realise funds, including shares in the acquiring entity within the purchase price can be an attractive offer, especially if a further, more profitable sale is on the horizon. It can be difficult to determine the value of shares in a private limited company, however, this can provide commercial flexibility when negotiating them into the purchase price. Where the shares forming the consideration are publicly traded, a seller has the benefit of a potentially valuable and realisable asset (within certain restrictions) that can be an attractive prospect when the newly acquired business is set to become part of a successful and profitable corporate group.

Nevertheless, the transfer or issue of shares can have its drawbacks, as ceding any stake in an acquiring business can reduce the opportunities for future investment and tie a buyer to minority shareholders that do not necessarily align with their overall business strategy.

Although not exhaustive, understanding the flexibility of common options such as those discussed above can help to appropriately tailor an attractive offer.

Whether you are considering acquiring a business, selling a business or you are advising on such matters, our specialist Corporate lawyers would be happy to provide you with the support you need.

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