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Selling Your Creative Business – the headlines with Jo Evans

In this series, Joe and Ayesha from our M&A team, will talk to experts from across Lewis Silkin - sharing their top tips and valuable insights – about selling creative businesses.

Joe Lythgoe: Hello and welcome to Lewis Silkin's Podcast series '*Selling Your Creative Business'*. The series is hosted by me Joe Lythgoe, a Senior Associate in the corporate team here at Lewis Silkin.

Ayesha Chanda: And me Ayesha Chanda an Associate in the corporate team as well.

Joe Lythgoe: In this series we'll be getting insights and tips from experts across the firm who all use their different area of expertise to help creative businesses achieve their exits. Today, we're kicking off the series by putting some questions on preparing for an exit to Jo Evans, Lewis Silkin's Chair and a Partner in our corporate team.

Jo has more than 20 years' experience helping creative businesses achieve their exit, working across a range of creative sectors including marketing, PR, communications, gaming, digital, and media. Welcome Jo.

Jo Evans: Thank you, Joe and hello Ayesha.

Joe Lythgoe: Thanks for joining us. Let dive in. So, you've set up a creative business, it's doing really well and you're thinking about selling in a couple of years' time. What should you be thinking about from a legal perspective?

Key legal considerations for potential sellers

Jo Evans: Okay there's a few things to think about. A really important thing to get right is to make sure that as amongst the shareholders and the option holders, if you have any, is how you think you might want the sale proceeds to be shared amongst you is reflected in how your shares and options are currently owned and granted.

Two years out from a sale, you've got an opportunity to adjust that without any undue tax complications if it is not quite right. But making changes in the run up to a sale is much more difficult to achieve without tax consequences. And as an additional layer on that and thinking about how deals in the sector can often be structured. For example, with proceeds upfront and then deferred and contingent consideration later, look at the likely day one proceeds and how those would be allocated and make sure that you're getting the balance as amongst the team right. That's the first really important thing. Some other things, if you do have EMI options, and I have a feeling we're going to talk about those quite a bit.

Joe Lythgoe: Yeah, we've got a podcast just for EMI options coming up so we're on it.

Jo Evans: Very good. So, I'll just do headline things and I'll leave the in-depth that later podcast. So, if you have got EMI options, it's really important to get a health check on them. Again, two years out, you've got the time to correct any mistakes and maybe grant additional options for the maximum post tax benefit. Issues which arise late in the day, often during the due diligence (DD) on a sale are really difficult and expensive to sort out later.

Joe Lythgoe: And you talk about expensive, is that because you have to replicate them with bonuses which are fully PAYE, employers NICS (National Insurance Contributions) and all that sort of stuff.

Jo Evans: Exactly, and it just creates an issue on due diligence because teams who are doing due diligence for a buyer, they like nothing better than to find something that's wrong. And unfortunately, EMI options have provided plenty of fodder for those teams over recent years.

Joe Lythgoe: Yeah, we don't want to make their buyers lawyers happy, do we?

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Jo Evans: Exactly, or their tax advisors. So, getting the EMI right is really important. A few other things, make sure you've got written and signed contracts in place with your key customers and suppliers and you know where those are.

If you've done something from a corporate perspective which you're not sure about then again, two years out is a really good time to get that checked and sorted out. That might include things like a historic share buyback. So, you might have bought out a founder in years gone by and the process around that, it's quite straightforward but it's quite fiddly. Getting it wrong means that the process is just invalid. So, we like to do health checks on those things as well.

Joe Lythgoe: And I suppose, if you're going to try and do that shortly before an exit where you know the business is worth a huge amount, whoever you need signatures for might demand a higher price to give you their signature.

Jo Evans: Exactly, and again, it's just not the kind of thing you want to be focusing on when you're going through a sale process, there's lots of other things to think about rather than sorting out historic mistakes.

Have a look at your employment agreements and your policies and procedures and allied to that, look at your freelancer contracts because quite often those can crop up as creating problems as well, particularly around IP assignment. Again, look at your compliance and other matters like GDPR, data privacy and security protocols on data breaches and check up on filings for any IP protection like trademarks. Not strictly a legal thing but think about starting conversations with corporate finance advisors; I think it's really good to have some personal agency in a sale process rather than just being reactive to an out of the blue third-party approach. So, two years out those are the kind of things I'd be thinking about.

What value do corporate finance advisers bring to sellers?

Joe Lythgoe: And what sort of value do corporate finance bring to sellers?

Jo Evans: I think that they bring enormous value. There are some in our sector, who are, really well-versed in the sector. Very good inroads and links and networks with potential acquirers, people who you would just frankly, you've never heard of who might be a really good acquirer for your business. They're fantastically useful in the early commercial negotiations with the buyer, where sometimes it's good to have a third party having those, which might be quite difficult, price negotiations on your behalf rather than doing it principle-to-principle. Once you get into the sale process and starting to have negotiations around the equity value and working capital and those kind of things, then I think their advice and their expertise is just invaluable.

What sort of issues might stop or hold up an exit?

Ayesha Chanda: Thanks Jo. So, you've talked to us a little bit about the different areas where issues crop up in due diligence and how important it is to get ahead of those issues. In your experience, is there anything that might hold up or stop an exit?

Jo Evans: Yeah, I mean often things which do arise to frustrate a sale process are because the things that I've just highlighted have not been done or actioned, and issues arising on due diligence. They're many and varied right, depending on the agency and the business.

They don't prevent a deal from happening per se, but they can definitely cause delays, they might drive a price chip, or they can provide justification for a buyer to look for additional indemnities or reasons why sums of money from the sale proceeds should be held back until things are sorted out. They can be things like, as I said, problems with historical share capital history so poorly executed share buybacks, missing documents, misfiling's, issues with the EMI schemes. I'm not going to go on about issues with the EMI schemes, but they do crop up. And as Joe just said, resolving those can be expensive because of the tax consequences.

Less common now but, historically and may arise again are issues around leases, so historic liabilities, or failing to comply with lease obligations, or not providing properly for dilapidations; all of which go to value. And not dealing with historic rent deposits or guarantees and things like that, trying to get those released pre-completion. IP issues, and again this might be, failing to document properly, arrangements with your freelancers.

Tax issues, I mean during the pandemic, we had lots of agencies with people working overseas and there are issues around that from a tax perspective. We still do get questions and indemnities around covid loans and the implementation of the furlough schemes which all feels like a distant memory now, but it does crop up during due diligence.

Obviously, a big one is, unresolved litigation. If the company or the targets in the middle of any kind of cases, either prosecuting those or being prosecuted, then that's obviously not great. I think as a seller group, the aim should be a smooth and issue-free due diligence process. Actually, preparing for that is relatively straightforward. It's really just good corporate housekeeping and having a history of good corporate housekeeping.

Joe Lythgoe: I think what people underestimate is how much time it involves for the management team to run the sale process. The more you can do in advance, the better placed you are to deal with those things when you're not trying to do a million other things as well.

Jo Evans: Yeah, exactly right.

What non-legal issues can hold up or even stop a sale?

Joe Lythgoe: So, we've talked about the legal issues, you know we're lawyers, and we like to talk about legal issues. But what are the non-legal issues that you also see holding up or even stopping an exit in the extreme?

Jo Evans: Okay, I mean I think there's a few of those. Client issues I suppose I would put into one bucket. Those could be over reliance on a particular client and that will become readily apparent as soon as the buyers commercial due diligence team starts their work. We have situations where your business might have a particular client and then the buyer's group has got another client in the same group and if you're not able to navigate the conflicts between those two clients successfully then that has in the past created problems on transactions as well. Of course, if you should be unfortunate enough to lose a key client during the process then that will have an impact to.

Joe Lythgoe: Presumably that's something that corporate finance can help with as well. How to make yourself look good from a client and diversity perspective and how to pitch that to buyers.

Jo Evans: I suppose there's a limit to how much polishing you can do on that. Truthfully if you are over reliant on a particular client, you can't polish that away. That might be an issue. If you're starting two years out from a sale process and you have that as a business focus, for example, to increase the diversity of your client base then you know at least you're going into the process with your eyes wide open which is important.

Other issues, non-legal issues, erratic growth or profitability patterns and not being able to explain or justify those as part of the financial due diligence. Again, that might just become a pricing issue with the buyer looking to mitigate any risk by pushing sale proceeds later down the track. This is a key one, it goes back to the point you just made Joe, about the sale process taking up the management time; failing to hit your targets on profit and revenue during the process is really bad. It's so important to keep the business on track during that whole sale process. Often that can come down to resourcing, just making sure that someone has responsibility for managing the deal process and someone else has got responsibility for managing the business and isn't getting sucked into the deal process. Managing that is really important.

Another non legal point is you might have groups of sellers, or shareholders, or option holders in the business with different personal ambitions or expectations about what the sale might look like. Ironing that out at the beginning of the process rather than towards the end of the process I think is really good. Just making sure that everyone is aligned about what their individual and their collective objectives are from the whole outcome.

Joe Lythgoe: So, we're talking about where some people might want to cash out completely on completion and move away from the business. Whereas some of them might be next tier management that might take more of an earn out for instance.

Jo Evans: Exactly, exactly.

Jo Lythgoe: You don't want to be having those conversations a week before completion.

Jo Evans: No, absolutely. And again, if you can have those conversations two years before, then if you're trying to switch the balance between upfront consideration and earn out consideration between different people, you can actually do that using different share classes and that's just a really efficient way of doing it. But you can't be doing that at the time when you're actually talking to people about a sale just because it becomes a tax leakage opportunity if you do it then. But doing it two years out is definitely doable.

What are the different forms of exit available and how do they compare?

Ayesha Chanda: So, Jo you mentioned about the seller group generally being aligned and incentivised. What are the different forms of exit that are available and how do they compare? Is that something you recommend early on, that the sellers align on as well, depending on the outcome that they're expecting to get?

Jo Evans: Maybe, and I think conversations with corporate finance advisors will definitely help with that because each different kind of exit, depending on who the buyer is, has different drivers, different value points and will meet the expectations of some but not all sellers. So having an eye on that I think is really important, but I wouldn't narrow down your options by writing off one particular

group of buyers. Even though you might have three or four basic structures, even within those there are different kinds of buyers, offering different structures and more nuanced structures around each of them.

So, I wouldn't limit anyone, who their likely buyer might be by carving out people they're not going to talk to. I don't think that's sensible. But typically, you'll have a trade buyer and again typically, structuring on the value of that would be some cash or shares upfront and then a proportion of the value paid later, assuming the business hits certain metrics, usually around revenue and profit levels and margins. On those kind of structures sellers are typically tied in for a number of years. So, you'll have leaver provisions which will apply to the receipt of future proceeds, and broadly, “good leavers” will get the deferred payments and “bad leavers” won't.

And then obviously in our sector, private equity has been a big player now for the last five or six/seven years and there are two kinds of private equity buyer really. One is the first-time investment from a private equity firm. The sale proceeds there will be a mix of cash, maybe loan notes and equity in the buyer. And that might be allocated for example to cash and loan notes only where, for example, we've got founders who are exiting at the point of sale. And then a mix of cash and loan notes and equity in the buyer for sellers who might be rolling over. So, the resultant structure, you've got the private equity firm and then the rolling over management being aligned as co-owners. Often with shareholders and owners of debt in the business all incentivised to grow the business for the next event.

Joe Lythgoe: It feels very much like the theme here is that an exit might not quite be an exit in the sense that you're selling your company but having to stick around for a while. I suppose it feels like that might be because ultimately, we’re talking about creative businesses here and it's all about people and without the people they don't have any value for the buyer.

Jo Evans: Yeah, that's exactly right. It is all about people and their relationships with clients and the products and services which are being provided. You definitely shouldn't see an exit as an exit. If it’s a door marked exit, there's another door marked exit, just behind it.

Typically for private equity investments, they'll be looking to exit the business themselves three to five years down the line after a period of high growth and that's the basic private equity model with some debt in there, so that their returns are leveraged. And similarly, for trade buyers; you might sell on day one, but you won't get the full value possibly until three to five years down the line once you've maximised hopefully the earnout.

You've also got this kind of combination buyer in the market more recently, which is private equity backed businesses who’ve created a platform which are then making acquisitions of other businesses. That's like a combination of a trade buyer and a private equity buyer. So, you might get an earnout albeit a smaller, a shorter in length terms earnout, but you'll also get equity in the overall private equity structure as well. So again, cash, loan notes and some shares. And of course, we've still got the consultancies still making acquisitions in the sector as well. The big consulting firms like Accenture and others who are still very active in the market.

What’s one key takeaway for creative businesses looking to exit?

Joe Lythgoe: Thank you Jo that's really interesting and really helpful. Final question, what would be your one takeaway for creative businesses looking to exit?

Jo Evans: Okay, am I allowed two takeaways?

Joe Lythgoe: One main one and one small one maybe.

Jo Evans: Okay, my main takeaway then would be if you are a well-run, profitable creative business, you’ve got a unique proposition in the market then honestly, whether you're looking to set out to sell or not then you're likely to get approached and my one main takeaway would be to be prepared for that approach. So, if a sale is something that you envision as a possible future plan for your company, then run it properly from the outset so you're not trying to tidy things up later after you've had an approach and been taken by surprise. So, if that is the ultimate aim, then plan for that.

And my smaller takeaway, which we've mentioned already but is still really important is just don't take your eye off the ball of running the business during the process. Because if the sale doesn't happen, or it's delayed, or a price negotiation means that that particular sale doesn't happen, then you still want to be able to pick up the reins of the business and carry on after that. So, you very much have to run a dual track; keep the business going and keep the process going.

Joe Lythgoe: And also, if it’s going to be an earnout or you're going to have equity in the buyer then it’s in your interest right, for the business to keep running well, even if the sale does go ahead.

Jo Evans: Absolutely.

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Joe Lythgoe: Thank you Jo for sharing your expertise today and thank you to our listeners for joining. If you would like to find out more about anything discussed in this podcast, please get in touch with me or Ayesha, our details are on the Lewis Silkin website and do look out for more podcasts in this series '*Selling Your Creative Business*'.

Get in touch with our team for more information about the topics discussed in this podcast.

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