

Chapter 3 The growing business

Questions

1. Des Wynne and Penny Forster have run a successful PR business for many years trading as Wynne Forster PR. Their main source of income is fees for advice from large companies. In this specialist field, Des and Penny are well-known and well-respected. Their firm, which is run as a partnership, employs three junior staff, all of whom have worked for the business for at least five years. Both the partners are now nearing their late forties and are starting to think about retirement. Although they don't wish to retire immediately, they would ideally like to have retired by age 55. Both partners have invested in retirement funds over the years, and they will have an adequate pension. However, they reason that they should be able to make some cash out of selling the business, because it has such a good reputation.

Required: advise the partners on the principal issues and problems that arise in extracting retirement funds from their business.

2. Idris Evans runs a small chain of dry cleaners situated in the suburbs of a large city. The chain comprises four shops that he has opened at the rate of approximately one every five years since he started up in business as a young man. Idris's business has always been profitable and he currently has some spare cash that he would like to invest. Idris knows that the city is unlikely to support another dry cleaners unless one of his competitors goes out of business, and so he is thinking about expanding into a nearby town. Whenever he has expanded his chain in the past he has set up the business from scratch and he would be prepared to take this approach again in the expansion into another town. However, this time, by coincidence, a well-established dry cleaning business is on the market in the town he has targeted. Idris is hesitant about putting in an offer for the business because the price seems very high. He knows that the price no doubt reflects some element of goodwill, but he thinks that the goodwill element may be overvalued.

As Idris's business adviser, advise him on the factors which you consider to be relevant to his decision on whether to expand the business by gradual growth or by acquiring an established dry cleaning outlet. Include an assessment of any risks you identify in either approach to expanding the business.

Answers

Note that there are many valid points that can be mentioned in the answers to both of the questions. The answers below include a selection of relevant points, but you may be able to think of others.

1. Wynne and Forster

The partners do not wish to retire immediately, so there is some time available for planning and executing an appropriate exit strategy. The principal value in their business is likely to lie in its reputation; however, much of that reputation is currently dependent upon the two partners themselves. If they go, how much value is left in the business? (Note that it is possible that there are more obvious sources of value in the business: for example the partnership might own premises which could be sold or leased to provide cash. More information would be needed on this point). If the partners try to sell the business on its own (i.e. without their own services) it probably will not fetch very much.

The partners are not the only people generating fees in the business. Their junior staff are all, it appears, quite experienced, so it is reasonable to suppose that they contribute towards the fee-earning capacity of the business. In the circumstances, the most sensible strategy may be to bring one or more of the staff into the partnership. The two existing partners could give up a portion of the partnership in exchange for cash. For example, if they decided to invite two of the staff to join the partnership they could gradually transfer control of the business to them over a period of four or five years. The new partners might not be able to put up the money straight away but might well be able to find the finance over a few years. The business would have to be valued so that an appropriate level of contribution could be agreed between the existing and the new partners.

The strategy outlined above is often appropriate where the principal value of a business lies in the skills of its proprietors. An alternative proposal would be to merge the business with one of its competitors who might be interested in acquiring the name and reputation of the business. However, if there really is very little value in the business's reputation and brand name, the partners may simply have to accept that it will cease to exist when they finally retire.

2. Idris

Relevant factors include:

- a) *Valuation of goodwill.* The vendor of the business should be able to provide a break-down of the valuation so that Idris can establish just how much is being asked for the goodwill and the other elements (e.g. premises and equipment) included in the asking price. Idris needs (probably with the assistance of professional advisers) to examine each element of the overall valuation and to assess whether or not it is reasonable. In any case, the vendor almost certainly expects to receive offers lower than his/her asking price, and will very likely be willing to negotiate.
- b) *Reasons for sale.* It may be quite easy to establish the reason for the sale if, for example, the vendor is retiring. If the reason is not obvious Idris may have to investigate more thoroughly. It could be that trade is declining and the vendor wants to make an exit before it gets any worse. Or, perhaps a new road scheme will tend to take business away. Or, perhaps a more effective competitor has set up and is taking away market share.
- c) *Examining the alternative:* expanding the business by gradual growth. The advantage of expanding by starting up a new outlet from scratch is that Idris has done it before and must have a pretty good idea of the costs and effort involved.

Risks

The risks of expanding by opening a new outlet include the following:

- Idris is possibly less familiar with the trading conditions in the target town. He may make the wrong decision about location.
- Idris may have more difficulty controlling an outlet in a more remote location.

The risks of expanding by acquiring the existing business include:

- Paying too much. Idris is obviously keenly aware of this particular risk
- Buying a business that is in decline. Idris will need to examine the profitability of the business carefully, by looking at its recent accounts.