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The Top 10 Deal Killers: How to Avoid Them

It's an all too familiar story line in the deal business. After months of hard work and in many cases hundreds of thousands of dollars in legal fees and expenses, the deal blows up. Most of the time it's solely the fault of the participants, usually the seller, but sometimes external factors can add to the risk of deal failure. The really unfortunate thing about these bad outcomes is that many can be avoided with careful planning, due diligence preparation and just plain common sense. This article addresses the Top Ten Deal killers and offers some suggestions on how to avoid them.

1. Failure to validate the value of the acquisition to the buyer

A properly conceived strategic marketing plan identifies the correct buyers enabling the sell side deal team to tactically articulate a compelling business case to the buyer. The key is to be sure that the best buyers are targeted; those buyers to whom the acquisition will add the most value for specific reasons. Ultimately the process culminates in the "best buyer" paying the highest price available in the marketplace for the business because the best buyer can generate the highest cash flows for the business. Accordingly, the best buyer possesses some distinct advantages for owning the business. These may include cross linkages to other buyer owned business, unique sales forces or distribution capability, and better access to, or control over, critical resources.

A good example is General Mills' purchase of Pillsbury from Diageo in 2001 for $10.4 billion. Both General Mills and Pillsbury are in the packaged food business, while Diageo is primarily in the alcoholic beverages business and ran Pillsbury as a standalone operation. General Mills was able to integrate Pillsbury into its packaged food operations leveraging purchasing, manufacturing, distribution and marketing. To boost revenues, General Mills introduced Pillsbury products to the "school lunch" market where General Mills already had a strong presence. And lastly, General Mills distributed newly introduced Pillsbury refrigerated products on its fleet of refrigerated trucks. All in all, General Mills boosted Pillsbury's operating profits by 70%. The price General Mills paid was less than the value to General Mills but more than the value to Diageo to continue to operate the business. Hence, the deal got done.

If the seller cannot communicate a business case to the buyer similar to the above example, at some point the buyer's deal team will blow the deal up. Put differently, the buyer must be able to see the synergies that justify the goodwill needed to pay the price to induce the seller to sell or the deal will not happen.

This revelation can occur at any point in the M&A process. Once this tipping point is breached, there is no second chance. The deal is DOA. To be a successful seller, think like a buyer.

2. Inability to confirm ownership of assets, specifically intellectual property assets

Usually this problem crops up in information technology deals where the intellectual property is critical to the cash flow. The seller must be able to provide proof of ownership of internally developed technologies, identify any 3rd party technologies used in the products, and then establish that the seller has the rights to sell the technology. Sorting this out and having to remediate technology differences can be very time consuming. If the buyer smells any risk here, boom; good bye deal.

Conduct an intellectual property audit before going to market, fully resolve the issues and then sell the company. Bear in mind, most technology companies are bought, not sold. Be ready when the buyer comes knocking.

3. Unprepared for the buyer's due diligence team

The fact is that most buyers' due diligence teams can easily overwhelm the seller. These teams do acquisitions for a living and show up on the seller's door step in the form of the operations team, the administrative team, the legal term and the finance crew. Typically, each team is armed with deep deal experience (not their first rodeo), and massively comprehensive checklists. The seller, for whom this rodeo is probably the first, is faced with responding to this juggernaut while all the while continuing to run the business. In some cases, these teams can literally outnumber the corresponding functional departments for the seller. What's a mother to do?

The short and simple answer can be found with the Boy Scouts. Be prepared. The time to begin getting the house in order is not the day after the Letter of Intent is signed. The seller must commit to the sale prior to going to the marketplace and make an investment in preparation without having that magic number, the price, known up front. Being unprepared impacts the deal's timing and gives rise to the axiom, time kills deals for sellers but offers buyers the best due diligence. As a seller, time during the due diligence process is not your friend. The longer it drags on the more the buyer can grind and eventually, the deal blows up; typically it's the seller who lights the fuse in this situation.

4. Poor accounting records and procedures

Businesses are valued as a function of cash flow which is measured in the accounting records. An inability to accurately gage the cash flow due to poor accounting is a double whammy; the buyer is going to err on the lower side (less cash flow) and perceive an increased risk, both of which combine to drive down the value and eventually the pricing. This issue can come to the point where the parties can no longer agree on price, the deal falls outside the "solution zone" and blows up.

The fix is for the seller to invest some money in the accounting, reviewed statements at a minimum, audited preferable. In addition to making the business more valuable, the improved command and control of good accounting systems might even make it easier to run the business, leading to better decision making an enhanced cash flow. Either way, good accounting is a good investment.

5. The seller misses the forecast

This deal killer is somewhat of a corollary to number 4 in that good accounting should help the seller forecast, and forecast accurately. The buyer "price justifies" in part on certain assumptions about the seller meeting the forecast; after all the buyer is buying next year's earnings not last year's. Unless the seller has a really good explanation for a small miss in the forecast, the deal blows up. A big miss in the forecast and it blows up for sure. The miss can go either way with the same consequences. If the business is underperforming the forecast, the buyer pulls the plug or demands a lower price; over performing and the seller pulls the plug or demands a higher price. In either case the deal goes on life support. The best practice here is to forecast conservatively by forecasting to a base line case that reflects the recent past and justifies the seller's pricing target. (If that can't be done, sound retreat, fall back and regroup.) The business performance should comfortably meet or marginally exceed the forecast. Put the hockey stick back in the locker.

6. The buyer discovers a major, undisclosed negative issue

Typically these problems involve items like a contract novation, environmental or labor issues, or unresolved litigation. Once an undisclosed issue is surfaced, the seller's credibility is shot (what else didn't they tell us) and trust is lost. This deal killer goes in the ten kiloton category because there is no surviving it.

These types of hurdles can be overcome simply through full disclosure. Rest assured those due diligence teams are going to turn over every rock so it's best to put it on the table right up front and deal with it as part of the process. If the objective is to sell a problem, it's an exercise in wasting time and money on futility. And, if it can't be fixed, it can't be sold.

7. Key employees hold the deal hostage

Key employees can be a highly contentious situation when it comes time for the business owner to cash in for millions of dollars. After all the key employees are important to the buyer and the key employees helped to build the business; this circumstance can lead the key employees to feel cheated and consequently threaten to walk out and start a competing business tomorrow. (Yes this kind of stuff really does happen.) Key employee leverage, if unresolved, can be fatal to the deal.

Avoiding this deal killer is relatively easy. Get noncompete and nonintervention agreements in place with key employees before taking the company to market. Also, carefully document any promises made about key employee rewards and incentives beforehand.

8. Buyer retrades on the price and terms set out in the Letter of Intent

If due diligence drags on for a long time, the buyer can turn that process from what should be a confirmation exercise into a witch hunt. In such cases, the buyer is going to find reasons why the price and terms set in the LOI prior to due diligence need to be changed, always lower. The timing for this revelation will be about two days prior to scheduled closing, after a mountain of time, money and emotional capital has been invested in the deal. Believe it or not, this instance is inevitable with unmanaged due diligence and even more surprisingly, a savvy buyer can successfully employ this tactic.

The seller, beaten down by that due diligence swat team, fatigued with running the business and fighting the buyer, succumbs to a lower price to get the deal done. In really egregious situations, the seller blows up the deal.

Once an LOI is negotiated and accepted by the seller, the negotiating leverage at this point shifts to the buyer for two reasons; exclusivity (no shop) and confidentiality, the only two parts of most LOI's that are legally enforceable. The other bidders go away and the seller is left with the buyer largely controlling the pace, particularly if the seller is unprepared for that due diligence swat team.

To mitigate this situation, it is imperative that the seller get as much detail about the price and terms into the LOI up front in order to narrow the latitude a buyer has to retrade. A key area in this regard is the definition of the scope and duration of the due diligence and an emphasis that due diligence is a confirming exercise and not a hunt for reasons to lower the price. The time to be tough about the price and terms is in the LOI before a buyer's offer is selected.

9. Litigation!

Like a lighting strike to the heart of the deal, litigation commenced against the seller at any time during the M&A process is fatal. The best course of action is to withdraw the business from the market until the litigation is resolved. Very few people would be willing to pay good money to buy a lawsuit. Everyone knows you get enemies for free and its friends you have to buy.

Past litigation should be disclosed and if the seller is famous for suing or being sued it's not going to reflect well on the business; litigation adds risk and enormous cost, less cash flow, higher risk, lower valuation. Most savvy buyers understand that litigation is a cost of doing business in our modem world but no one actively seeks it out.

10. Failure to reach agreement on the breadth, depth and remedies embodied in the representations and warranties

Negotiating the reps and warranties is an exercise in allocating risk. At one end, the buyer would like the seller to guarantee every possible contingency and take all the risk out of buying and owning the business for the benefit of the buyers, and not just to the extent of the purchase price. At the other extreme the seller prefers to have all the money up front, in cash, and the business sold where is as is. Caveat emptor.

These negotiations can be among the most heated and contentious in the entire process. And while the risks and fears of the unknown loom large in both the minds of the seller and the buyer, in the minds of the seller and buyer is the only place such extremes really rest. Nonetheless, if common ground cannot be found or the deal teams are unable to manage the sometimes outsized egos of their respective principals, or if a perception coalesces around the notion that one party is paying too much or the other party is getting too little, the deal will die at the reps and warranties stage.

If the process is well run and the deal is firmly in the solution zone, generally the parties can come to terms on the reps and warranties. If not, a number of large insurance companies underwrite breach of reps and warranties insurance which comes with high deductibles (typically first $500 thousand for $10 million of insurance), depending on the situation, the premiums, in my experience, are reasonable and could be less than the legal fees to wrangle over the reps and warranties.

Summary

Some of my colleagues may be surprised that lawyers and accountants aren't even given an honorable mention on my list of top ten deal killers. That's because lawyers and accountants don't kill deals.

Unprepared and unadvised sellers inexperienced in the M&A process kill deals by mindlessly driving the deal into kill zone situations from which there is no escape. And finally, the best hope of avoiding deal killers is to ensure that competent and licensed investment banking professionals reside on both sides of the transaction. After all, these are the only people who don't get paid if the deal gets killed. It's a powerful incentive.

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