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Avoid These Four Mid-Market Deal Killers

Takeaway: Few experiences in business are more harrowing than having a deal to sell your company fall apart. While the ups and downs of a deal are inevitable, having your transaction get permanently derailed is not.

When a deal crashes and burns, the repercussions on your business can be significant and long lasting. Company performance may suffer as management takes its eye off of day-to-day operations. Key employees get spooked and leave because of the anticipated change of control. The window of opportunity for selling your business may narrow, if not close all together. All of these outcomes can contribute to lowering the company's eventual sale price.
There are some common reasons why deals falter. Understanding these deal killers can help you take the necessary steps in advance to assure that your deal doesn't sink when it hits some rough waters.

Deal Killer #1: Loss of Seller Credibility
The last thing you want to do during negotiations for the sale of a business is to lose credibility with the buyer. You want all of your buyer interactions to reinforce that you are on top of your game, as opposed to, it's amateur hour.

Certainly, how sensitive buyers are to credibility issues varies from deal to deal and from buyer to buyer. However, for all buyers the momentum and excitement that has hopefully been built overtime can be quickly overcome by the number of red flags that emerge due to one or several of the following issues.

• **Material miss to forecast.** Having a command of the key financial metrics that inform your expected financial performance is second to none when it comes to helping or hurting your credibility with buyers. There is nothing worse than when a seller needs to report a material miss to their forecasted results. For instance, we had one client situation whereby the Company missed its year-end target by close to 20%. This spooked several of the larger, publicly traded buyers because it suggested a lack of revenue predictability and strong execution.

• **"Blue-sky" forecast.** When selling, people have a tendency to tell a buyer what they'd like the results to be rather than what it is. While everybody understands that forecasting is part art and part science, an unsupportable forecast is an immediate and assured way to lose credibility. You need to support your forecast both top down and bottom up and then leave yourself a 5-10% margin of error, so you are more likely to under promise and over deliver.

• **Not speaking with one voice.** Another way to potentially jeopardize your credibility occurs when team members give different and possibly even conflicting explanations about key issues such as business strategy. If a buyer is hearing five different business strategies from five different team members, alarm bells are bound to go off. Buyers may even try to isolate a certain team member to troll for information. Make sure all of your team members are singing from the same hymnal. If your messaging doesn't sound consistent, it reflects poorly on the company and how it's being run and highlights potential issues.

• **Present a perfect company.** Another red flag for buyers is when there is nothing wrong with the company. Buyers want to hear where there are areas of improvement, since in most cases scaling the seller's business to 5-10X its current size is integral to their investment thesis. A constructive way to talk about areas of improvement is to do so in the context of potential synergies between the two businesses. This approach not only demonstrates the future value you'll provide to the buyer but also communicates what you are looking for in a partner.

•**Lack luster presentation.** A lack of passion in the seller's presentation and a lack of management coordination is a potentially fatal flaw. Not only does the team have to be coordinated, but the presentation and the written materials have to be consistent; if the company doesn't "own" the materials, it will show.

• **Inability to respond in a timely fashion.** Haphazard and delayed responses during due diligence is a red flag that not only hurts credibility but also usually elongates the due diligence process itself. Similarly, if your data room is not well organized and/or thin buyers will infer one of two things, both of which hurt the seller's credibility. First, the seller is trying to shield potentially damaging information. Second, the Company does not have its ducks in a row and/or said another way the Company's internal systems, controls and overall organization are weak.

• **Surprises during due diligence.** The worst thing is to have a major issue or liability be discovered during due diligence, since at that point the negotiation, due diligence should be confirmatory not evaluatory. Moreover, once you've signed an LOI and entered an exclusivity period, leverage shifts from the seller to the buyer. In general, more often than not if something is going to cause a deal not to proceed early on, it will cause it not to be consummated later as well, so you might as well get sensitive issues out in the open early, where you have a good chance to positioning the issue and managing the negative impact. If a seller waits and the late disclosure causes the buyer to decide not to consummate the deal, then the seller has incurred costs, taken valuable time away from the operation of its business and generally weakened the company. The good news is that most of these pitfalls can be proactively mitigated with solid preparation and advice.

Deal Killer #2: Lost Momentum

Deals are all about timing and momentum. When a deal drags on and on, people lose focus and move onto other things; this is especially true with larger buyers who are actively seeking to complete a number of transactions in the same time period. When the key decision makers on both sides of the table are focused, you need to take advantage of having their attention and move the deal along quickly. You need to avoid having due diligence take an inordinate amount of time or having numerous drafts of the documents go between the parties and their lawyers because you'll lose that momentum and once you lose momentum, deal fatigue kicks in and deals will not get done. Many a good deal has been lost or delayed because of inexperienced or over exuberant attorneys compelled to negotiate every detail, even when they are immaterial. See our recent blog on selecting a good M&A attorney to ensure you don't experience this pitfall.

I recently faced a situation whereby we needed to either close by the end of the month or the deal would be pushed out at least 30 days, due to the buyer's reporting constraints. There are a lot of things that can go wrong in 30 days such as your champion leaving the company, change in strategy/direction, or a shift in priorities. Therefore, you always want to keep the seller's transactional team focused on resolving the critical path issues and not wasting time negotiating points that have limited impact on the seller. Similarly, in the case of financially sponsored deals where a platform investment company is doing an acquisition, make sure you have champions at both the acquiring company and the private equity group. In every case, whether it is a financial or strategic buyer, the board is going to have to authorize the deal, so make sure to maintain good visibility into the board's support for your deal.

Deal Killer #3: Erroneous Expectations
Many sellers, especially those who are selling a business for the first time, enter the process with naive expectations about a wide variety of issues that can eventually bring down a deal.

• **What's it worth?** Perhaps chief among the faulty expectations first-time sellers bring to a deal is the price their company will fetch. It's not uncommon that a seller latches onto M&A and/or public company valuation comparables that are extraordinary and ultimately not that comparable. For instance, one of my favorites I hear is that I'm a SaaS business so shouldn't I get 9x revenue multiple since that's what Saleforce and other SaaS businesses command. Unfortunately, some advisors/intermediaries compound the situation by telling the business owner what they want to hear which is that their kid is the best looking in the class and thus will command an extraordinary result. Before you make that mistake, ask the advisor to explain how your business is comparable to a multi-billion dollar, publicly traded and rapidly growing before you start spending the money. In other words, don't mistake a selling tactic with confidence in generating an extraordinary result.

• **Emotionally unprepared to sell business.** One of the hardest things for a founder/owner/operator to do is to emotionally prepare themselves for what happens after they sell their business. This type of emotional reflection is easier said than done and as such often gets postponed until the owner is faced with either a letter of intent or even worse the signing of a purchase and sale agreement. At both of these deal milestones the seller will have invested a lot of time, energy, effort and money, so facing these types of questions for the 1st time in the 11th hour should be avoided. So before you parlay being approached by an unsolicited buyer into exploring a sale process, make sure you have thought through and are emotionally prepared to not only lose control and determine what happens next, but also the prospect of having a boss for the first time, possibly ever.

• **Failing to align managers' incentives before the sale process begins.** Determine in advance of the sale process how to reward key managers who are integral to having a successful sale. Otherwise, you find yourself in the position of doing this at the 11thhour when key employees have increased leverage and may ask for things that are unrealistic from the buyer's and/or seller's viewpoint. For instance, I've seen a President, and key employee in the eyes of the buyer, get fired at the 11th hour due to insubordination. Suffice it to say, this put the deal at jeopardy, so be proactive not reactive.

Deal Killer #4: Taxing Tax Issues
Sometimes deals buckle because of tax situations that come to light during due diligence. Taxes of all sorts-state sales and use taxes, payroll taxes, state income taxes, taxes owed for doing business in foreign jurisdictions–can cause problems. This list of potential problem areas continues to grow, as issues such as IRS Section 409A come to bear in M&A transactions.

Most recently, we seen several deals either go off of the tracks and/or require the seller to take on greater risk in the form of a larger escrow because of “off-balance sheet” sales tax related issues. The analysis of sales tax exposure is complex because each state has different laws and requirements. This has become more of an issue because State tax collectors have gotten more aggressive given budget shortfalls.

Generally speaking, buyers are always going to be extremely conservative when it comes to sales tax treatment, since the buyer inherits sales tax liability in both stock and asset purchases. These issues vary greatly from company to company so we can only give the broadest possible advice, which is to consult with your tax attorney and accountant well in advance of entering into the market. More specifically, you can have a qualified tax professional do a sales tax audit so you know if and where you might have sales tax exposure. Similarly, if you’ve based your position on why you have not paid sales tax in certain states, such as a manufacturing exemption, make sure you have the supporting documentation on file, such as copies of your client’s tax exemption certificates. This will go a long way in making the buyer more comfortable with your position.

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About Peter Alternative

Peter Alternative is a Partner at Mirus Capital Advisors. Peter brings over 15 years of experience advising middle market, technology-based companies. He has been a financial advisor to both public and closely-held companies on divestitures, capital raising, recapitalizations, strategic acquisitions, mergers and cross-border transactions. Full Bio