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Case Study: Failed Deal – Loss of Trust

Although I am reluctant to admit it, sometimes the deals I have been involved with don't make it across the finish line. When a deal fails, that is an opportunity for me to examine my processes to determine where the train jumped the track. What did I do wrong, if anything? How can I improve and hopefully avoid duplicating the same errors? Let's take a look at one such failure.

My client was a fifteen-year old mom and pop operation ("the Company") that supplied proprietary chemical products to the oil and gas industry. The Company's primary customers were involved with fracking - the injection of fluid into shale beds at high pressure in order to free up petroleum resources such as oil or natural gas.

Typical of many mom and pop operations, this husband and wife team lacked a dedicated marketing program. In essence, they were reliant on "word of mouth" marketing and a website. In spite of this marketing deficit, the Company provided them with a very comfortable, although less-than-predictable lifestyle. Evidence of this lack of predictability is demonstrated by the chart below.

	Jan - Dec 2009	Jan - Dec 2010	Jan - Dec 2011	Jan - Dec 2012
Revenue	1,461,409	2,721,773	2,625,789	3,854,249
COGS	263,713	485,296	447,589	645,659
Gross Profit	1,197,696	2,236,477	2,178,200	3,208,590
Expenses	842,302	1,073,796	1,196,215	1,137,760
Net Income	355,394	1,162,681	981,985	2,070,830
Adjustments	108,655	119,336	146,799	234,829
Adjusted EBITDA	464,049	1,282,017	1,128,784	2,305,659

Top and bottom line results demonstrate that the business improved dramatically from 2009 to 2010, took a slight dip in 2011, and then rebounded very nicely in 2012.

Early discussion with the Company focused on their desire to sell the business so mom and pop could devote more time to family and other personal pursuits. As I learned more about their goals and objectives, it occurred to me that a recapitalization with a private equity partner made a lot of sense. A recapitalization would (1) basically transfer their business-related personal guarantees to a financial partner, (2) relieve them of their day-to-day operational duties, (3) provide them with a nice pile of cash at Closing and (4) offer a second bite of the apple a few years down the road. As for their employees, their top man would assume control of the day-to-day operational duties and all of the employees

would benefit because of the growth that would occur after completing a deal with a financial partner who had a history of growing companies and rewarding employees.

Based on what appeared to be a total winning strategy in accordance with my client's goals and objectives, we took the Company to market in early 2013 and began to receive indications of interest. After a series of interviews with prospective partners, we agreed on terms and conditions of a Letter of Intent with Chemical Capital Partners (CCP) in November 2012 for $10 million. The deal was structured as an 80/20 recapitalization and due diligence began soon thereafter.

As we began the due diligence process, CCP's attorney drafted an Asset Purchase Agreement (APA). While reviewing the APA with my client and their attorney, I began to remember why it's a good idea to meet a client's advisors early in the process.

If I had done that, then I would have known that my client intended to use his long-time friend, a gentleman who practiced will and probate law…not business acquisition transfers. Let's assign the name Mr. Smith to the attorney. Because he had no practical experience in this arena, Mr. Smith was smart enough to know that he needed to bring in another attorney to help out. Using his best judgment, he selected another friend, a tax attorney. Well, I couldn't argue with bringing in a tax attorney except for the fact that he also had no business acquisition transfer experience to speak of. Oh well, the show must go on. There was a deal to do here!

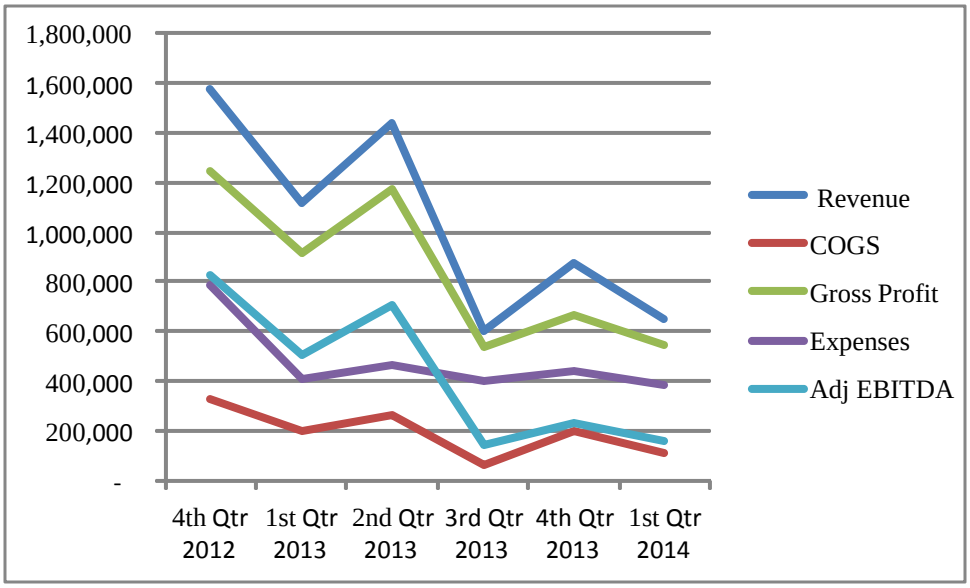
As weeks turned into months because, dare I say, my client's attorneys were working in unfamiliar territory, something unexpected happened…. Mr. Smith, the will and probate attorney, began sharing his valuation ideas with my client. For whatever reason, my client fell victim to the belief that the agreed upon value of $10 million was now too low for him to accept. More on the valuation issue later.

While the APA negotiations and due diligence continued, CCP shopped for a suitable lender. After the lender was selected, it was discovered that my client had a customer concentration issue. Let me explain. My client had numerous customers and none represented more than a reasonable amount of annual revenue. The lender balked because the majority of my client's customers were actively engaged in the same geographic area, a seemingly natural occurrence due to the fact that exploration companies go to where the productive drilling takes place.

Armed with this lender information, CCP explained to my client that a geographic diversification was needed in order for CCP to obtain acquisition financing.

This is where the lack of a marketing campaign and a complete reliance on a limited number of customers comes into play. My client objected to the idea of trying to develop new customers at this stage of the game. He had already mentally checked out. Instead of diversifying his customer base, my Client actually began to *lose* customers as those customers began to reduce their fracking activities.

During a period of the next six (6) quarters, the following chart demonstrates what happened financially to my client's business.



Now let's get back to the valuation issue. Based on my experience and an awareness of my client's financial free fall, I could not agree with Mr. Smith's assertion that my client's business was worth more than $10 million. Because I disagreed with a higher valuation at this stage, my client determined that I had conspired with CCP to "steal" his company for the low, low price of only $10 million. As you might expect, he lost faith in me and in CCP.

During this disturbing period of lost customers, revenue and bottom line performance, you may find it difficult to believe, but CCP was still deeply committed to the acquisition. That commitment was not because of any faith in my client, but because of CCP's faith in their ability to grow the business.

As you probably guessed by now, traditional means of financing sources dried up, thereby requiring a Seller Note to get the deal done. Because of my client's lack of trust, he was *sure* that CCP would default on the Seller Note. He refused all offers from CCP (the only prospective buyer that was still interested in the Company) that contained a Seller Note with him as the primary lien holder regardless of the size of the Note.

Searching outside the box for creative ways to get the deal done, one last attempt was made. CCP asked the question, "Would you accept an all cash offer, paid in full at Closing and no Seller Note?"

Believe it or not, my client rejected this final offer, again declaring that he did not trust me or CCP.

Subsequent to the rejection of the cash offer and based on a letter from Mr. Smith, all negotiations with CCP ended and my sell-side agreement was terminated.

So what lessons did I learn from this unsatisfying experience?

Issue #1: Always require a commitment fee or retainer. Because I had known the husband and wife team for a couple of years through a local networking group, I had agreed to accept them as a client and waived my customary commitment fee. This may or may not have been an error in my judgment. As a professional, I like to think that my services have some value. However, I realize that the payment of a

commitment fee or retainer does not guarantee that my client would ever agree to completing a deal. Besides, it's the success fee that we collect after crossing the finish line that matters. It's not the commitment fee or retainer that helps us measure our abilities as a professional advisor.

Issue #2: Meet the advisors. I dropped the ball on this one because I did not insist on meeting my client's advisors. After the fact, my attempts to insert a transaction attorney and a transaction CPA into the deal fell on deaf ears.

Issue #3: Ask the right questions. It's not just about asking questions, but rather asking the right questions until you get the most accurate answer, which is not often the answer the client wants us to know. In this case, I received monthly financial statements and compiled a trailing 12-month Excel spreadsheet. Yes, I could see the decline, but I did not ask about the loss of customers. Shame on me.

Issue #4: Time is of the essence. Anyone who has been in the profession for any length of time soon realizes the old adage that time is a deal-killer. The fact that this one dragged on for more than a year and a half is a testament to that fact. I can't help but think that if my client had accepted seasoned professionals into the mix, we might have completed a deal before the loss of customers, revenue, adjusted EBITDA, and trust.

As you read this article, perhaps you discovered lessons other than the four issues mentioned above that you can apply to your practice. I hope so. It's better to learn from each other's experiences than it is to learn the hard way…at your expense.