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12 THINGS NOT TO DO IN M&A

A GUIDE FOR CEOS

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For most owners, exiting their business is a once-in-lifetime event.

It's also an inherently complex process. Though every transaction is different, there are a few common missteps owners should take pains to avoid.

We talked to 10 investment bankers, investors, and former business owners who have been through a deal about their top tips for what not to do during M&A.

FEATURED CONTRIBUTORS

BKD LLP CPAs & Advisors

BTA Business Transition Academy

Circuitronics

dando

Longwater Opportunities

Momentum Physical Therapy

QuietLight Brokerage

Sterling Partners

Strategic Value Advisors

ValueScope

Don’t overlook exit planning.

By Chris Schumann, **BKD Corporate Finance, LLC**

How well you manage and prepare for a succession event may be the decisive factor in the overall financial success of your business and its stakeholders.

Given the obvious need and benefits of developing a succession plan, why do so many fail to do so? First, day-to-day operational demands seem more urgent than “long-term” succession planning. Second, more often than not, leadership hasn’t been through a succession event, and the lack of knowledge and experience related to developing a plan can easily lead to procrastination.

Not all succession plans are equal, and while a well-developed succession plan can perpetuate success, a poorly designed succession plan can lead to failure. An effective succession plan should include a thoughtful approach that accounts for the interplay among business, ownership, and family. If done correctly, a succession plan will align with your goals while addressing contingencies, gaps, and opportunities.

3 KEY COMPONENTS OF SUCCESSION PLANNING

1. **Discovery**
   Work with your advisor to gather information, identify stakeholders, and clarify objectives.
2. **Integrated Planning**
   Compare your current state to your desired state and develop a road map to meet your objectives; clarify stakeholder objectives, and reconcile differences
3. **Implementation**
   Make sure your advisor is involved in the implementation process.

Don't underestimate the importance of the right advisor.

Featuring Chad Elms, Former CEO, **Momentum Physical Therapy & Sports Rehab**

Chad Elms sold his business, Momentum Physical Therapy & Sports Rehab, to U.S. Physical Therapy Inc. in 2015.

"I honestly can't say enough about how helpful our advisor was throughout the process," says Chad. "I can't imagine trying to go through the process on our own."

3 Reasons You Need an Advisor

1. *Help position the company and maximize valuation*
2. *Get negotiation advice from experts*
3. *Increase the likelihood your transaction will close*

Before engaging **Martin Healthcare Advisors** through Axial, he had already received a few offers for the business. "We really thought, 'We've got this wrapped up, we don't need to bring anyone in at this point.' We thought we were standing at the 95-yard line with 5 yards to go." After bringing in an advisor, though, "it became apparent that we were standing at the 5-yard line with 95 to go. They helped us to see that this would be a marathon, not a sprint."

Chad says the offers the company received before engaging Martin Healthcare "were half of what we received after we brought them in."

In addition to helping maximize their valuation, Chad says that Martin Healthcare's "knowledge and experience in negotiating multitudes of previous M&A deals gave us insight on some of the other intangibles we needed to negotiate. Everyone thinks about the initial buy-out price, but not a lot of people put much thought into details like employment contracts, your specific role after the merger, earnouts, etc. Having a trusted advisor was invaluable for us in knowing what things we should be paying attention to, as well as what things were usual and customary to ask for throughout the negotiations."

A good advisor also greatly increases the likelihood that a transaction will close, by anticipating and addressing potential deal-killers well before they arise.

Don’t neglect your employees.

Featuring Sean Hutchinson, **Strategic Value Advisors**

Advisors and investors talk about a lot of strategies when it comes to maximizing company valuation before a transaction.

“One thing I have never seen on the list is employee engagement,” says Sean Hutchinson, founder and CEO of Strategic Value Advisors.

He gives the example of a $50 million business with 200 employees. Of that team, there might be a 10 person management team. Those 10 people can institute all the best practices out there, but “if you don’t communicate and engage with employees so they think and act like owners,” how can the company possibly sustain the improvements?

“They can’t,” says Hutchinson. The best programs “will never stick because the culture has not been adequately prepared to actually adopt the behaviors and best practices that go along with value creation.”

Hutchinson theorizes that part of the reason employee engagement isn’t a part of the conversation is because “we don’t like to manage people.” That includes owners, management teams, advisors, and investors. “It’s a painful territory, so we avoid it.”

“Everybody will say people are the heart of the company; people are the best asset. But if people aren’t engaged, if they are disconnected from the mission and purpose of the company, and they don’t understand why their contributions are valuable, you’ve got a huge problem,” says Hutchinson. “I wouldn’t invest in that kind of company.”

> *“If people aren’t engaged, if they are disconnected from the mission and purpose of the company, and they don’t understand why their contributions are valuable, you’ve got a huge problem.”*

Don’t fail to diversify your personal assets outside your business.

Featuring Jane Johnson, **Business Transition Academy**

While asset diversification is key to minimizing risk and generating the best returns in investing, some business owners are remiss to diversify assets outside of their businesses, perhaps because of a perceived loss of control. But the truth is, privately held companies are risky propositions. According to the Bureau of Labor Statistics, only 26% of businesses survive 15 years or more. Factors far outside the control of the owner including economic recessions and many other external forces like competition, technological advancements, health-care costs, and tax law changes can have dramatic impacts on a business.

Diversifying your investments and supplementing your income sources with non-business assets, such as real-estate rental income, interest, and dividends can help protect you from these risks. If your assets are well-diversified, you will be in better shape than an owner who is solely dependent on their business for income.

Saving money outside your business will also give you more choices when it comes time to transition out. For example, owners who have saved a lot outside may be able to afford to sell the company to family members or key employees who will not be able to pay top dollar for the company.

3 WAYS TO REDUCE YOUR DEPENDENCE ON YOUR BUSINESS

1. Take stock of your financial situation, including the assets you have saved outside the business and your annual budget.
2. Calculate your wealth gap, the difference between what you currently have saved outside the business and how much you need outside the business to generate your desired long-term income. Using assumptions, you can calculate how much money you need to net, after taxes and fees, from the sale.
3. Look at ways to diversify your investments and supplement your income sources with non-business assets.

Don't forget to get your financial house in order.

By Giff Constable, **Axial**

Getting your financial house in order is crucial to positioning yourself well in the market, improving your company's valuation, and running a smooth deal process.

Here are three things to keep in mind:

1 UNDERSTAND AND OPTIMIZE FOR YOUR COMPANY'S KEY VALUE DRIVERS.

Well before you actively start an exit process, think about how buyers might evaluate your company and then fine-tune your focus accordingly. For example, your company may be valued primarily for earnings, in which case you might restructure your business to improve gross and EBITDA margins. Or your company may be valued for its growth potential, in which case boosting earnings at the expense of (believable) growth may actually hurt you. M&A advisors who have done deals in your space will have useful insights for you here.

2 REDUCE FINANCIAL RISK.

Buyers want to be confident in the continued financial success of your business before doing a deal. One of the biggest areas of concern is excessive revenue (or profit) concentration with one or two big customers. Another is volatility of revenues, which is why companies with recurring revenues are often viewed as attractive. It takes time to correct such vulnerabilities, so start thinking about these risks early.

3 PREPARE FOR DUE DILIGENCE.

A fast, smooth deal process increases the odds of a successful outcome. Be ready for due diligence, which means getting your financials organized as much as your legal documents. Even if you don't have audited financials, get your books into a clean and accessible state. The more credible and professional you appear to potential buyers, the better.

Don't go overboard on EBITDA adjustments.

Featuring Chris Schumann, **BKD Corporate Finance, LLC**

"To reduce the likelihood of purchase price disputes, sellers should take caution to make sure adjustments to restated EBITDA are appropriate and supported through proper documentation. For instance, a manufacturer who has leveraged process changes or purchasing practices to drive EBITDA growth needs to depict or model the actual run rate improvements that they should get full credit for. This should be supported by data that demonstrates throughput rate increases and purchase price decreases," says Chris Schumann, Managing Director, Transaction Services at BKD.

Conducting sell-side due diligence, which usually covers financial statements, taxation, information systems, and operations, can help ensure that EBITDA addbacks are appropriate. "To position a company for a successful sale, we recommend beginning the sell-side due diligence process one to three years in advance of the anticipated sale."

ADVICE FROM A CEO COACH: "DON'T RELY ON HOPE"

"Hope is not a strategy. You don't have to have a perfect plan, but you need a strategy with goals. You need a management framework and a cadence to review that framework on a monthly or quarterly basis. Everyone needs to obsess over the strategy, otherwise going through a transition is going to be even more difficult."

-Kirk Dando, Dando Advisors

Don't let preconceived notions rule your deal process.

Featuring Jeff Forbes, Former CEO of **Circuitronics**

When Jeff Forbus, the CEO and owner of Circuitronics, a 37-year-old electronic manufacturing services company, decided his business was ready for outside capital, he wasn't sure that private equity was the right fit.

"Previously, my impression of private equity had been negative," says Jeff. "I thought the idea was to strip the company down, slash jobs, and flip it as quickly as they possibly could, while destroying the company in the process."

It took four months for the founders of private equity firm **LongWater Opportunities** to convince Jeff that they had the vision and skills to help his company succeed.

"Ultimately, I saw an opportunity for Circuitronics to go through its next stage of evolution," says Jeff. "It's like handing it off to the next steward, and I thought they would be good stewards of the business."

Together with Jeff, the firm aimed to build on the progress the business had already made by putting capital to work and leveraging operational expertise.

"In only five years, revenue and EBITDA grew by 355% and 740%, respectively."

"Jeff really cared about his employees, and I'm really proud that by the time we exited the business, we had more than quadrupled the workforce. We were also able to increase salaries and establish bonuses and other incentives for the entire workforce," says Jordan Bastable, co-founder of LongWater Opportunities. The cultural and operational changes implemented by LongWater translated into a remarkable improvement in the performance of the business. In only five years, revenue and EBITDA grew by 355% and 740%, respectively.

Don’t neglect to disclose important elements of your history.

By Mark Daoust, **Quiet Light Brokerage**

A few years ago, one of our advisors was helping a client sell his online business. He moved our client through the process of selling smoothly and without issue. It wasn’t long before a buyer was found and started doing his due diligence.

At the end of the due diligence period, however, the buyer discovered a previously undisclosed lawsuit. A few years back, our client was on the wrong end of a lawsuit, but when the buyer discovered this omission, it caused a ripple effect that eventually unraveled the deal.

The lawsuit itself was a non-issue. It was a frivolous lawsuit that the plaintiff quickly dropped. The problem was that it had been concealed.

It is not enough to simply disclose everything you are thinking of – you need to take stock of what you may have accidentally omitted and disclose that as well. Our client did not intentionally withhold information about the lawsuit from this buyer. He legitimately forgot it even happened since it was some years back and to him was a non-issue.

Remember to disclose everything, and take the time to identify anything you may have missed.

Don't overlook chemistry.

Featuring Whitney Krutulis, **Sterling Partners**

Every business owner wants the perfect fit when it comes to finding a buyer or growth partner. While financial considerations are important, chemistry between the founder and private equity group may be the most crucial indicator of a successful partnership.

"Culture is one of those precious intangibles that's incredibly important to both owners and employees," says Whitney Krutulis, Director of Business Development at Sterling Partners. "Any firm can say that they respect and appreciate culture, but sellers should look for a firm that walks the talk."

Observe potential partners closely during the courting and diligence processes. If you own a company that requires constant employee interaction, make sure when taking a tour of your potential partner's office that their employees are interacting with one another. It's important your company and partner understand how each company functions and that they complement one another. Compatibility can be elusive and hard to quantify, but you might observe them when visiting the firm's office, during meals or outings, and even on the phone.

ADVICE FROM A CEO COACH: "IT'S HARDER THAN YOU THINK"

"I tell people, you think it's going to be difficult, but it'll be 10-100 times more difficult than you anticipate. That's an important thing, because during stressful times, sometimes we look the other way on things we shouldn't. The process can have a way of wearing us down, and we need to stay strong on the long haul."

-Kirk Dando, Dando Advisors

Don’t neglect terms and obsess over price.

Featuring Giff Constable, **Axial**

“It’s absolute insanity to think about maximizing valuation at the expense of terms. This is true whether you’re taking a minority investment or selling,” says Giff Constable, former investment banker, CEO through 3 exits, and currently VP of Product at Axial.

Here are a few areas to focus on when evaluating the terms of a potential deal:

- **Consideration**: This refers to the way in which you and other shareholders will get paid, i.e., cash vs. stock. “If you get stock, it’s quite vulnerable to shifting,” says Constable.
- **Stock Protections:** When you receive stock, you want to think about a collar agreement to protect from movement while the transaction closes. Buyers might also try to insert language capping how high the stock can rise within a certain time period after the deal. Consider putting in a “floor” which protects you from the stock dropping too far.
- **Earnouts:** Earnouts are a common way to bridge the gap between a seller’s expectation of value and a buyer’s willingness to pay. “It’s a way to get the price up when the buyer’s struggling to justify your price expectations, but you have to consider whether the earnout is worth the risk,” says Constable. Even if you’re staying on after the sale, “your plan to hit that earnout could get totally blown out of the window by a restructuring, new management, or any of a number of other what-ifs.”
- **Reps and Warranties:** Reps and warranties refers to the “assertions that a buyer and/or seller makes in a purchase and sale agreement” (Divestopedia). As a seller, “the buyer will try to stick as many guarantees on you as possible — it’s your job, with your lawyer and banker’s help, to fight them off,” says Constable. Potential issues might include new lawsuits, environmental issues, and employee retention. Discuss these potential issues with your lawyers and banker and make sure that there are specific terms around each.

Don’t be naive about earnouts.

Featuring Scott Hakala, **ValueScope Inc.**

“Earnouts for sellers who are going to exit are too often a disaster,” says Scott Hakala, Principal at ValueScope Inc. “The best earnouts incentivize the people who run the business. Earnouts for CEOs who are just standing back and collecting a paycheck often aren’t good. Sellers always believe they’re going to make the earnout, then are mad if they don’t.”

Careful legal wording can protect against bad behavior, but even this doesn’t always work. Hakala tells a story of an exited owner with a 3-year earnout who watched from afar as the “buyer changed gears six months in and basically tanked the company.” He’s also seen rollups in which buyers deliberately credited the wrong business with sales in order to avoid paying an earnout.

Alternatives to earnouts include management incentive agreements, which should include assurances that the owner won’t be terminated if the company is acquired, and clawbacks, under which the owner can “claw back” equity if the company grows to a certain level.

ADVICE FROM A CEO COACH: DON’T TRY TO KEEP AN IMPOSSIBLE SECRET”

“If you’re going to share that you’re going through a transaction with your employees, depending on how open your organization is, my advice would be to keep people informed. If you try to keep a secret, it adds another layer of complexity. I strongly encourage you to have a contingency plan in that case, because it will leak. Even when people sign NDAs, it always leaks. Think about whether you want to be on the front end telling people, or the back end reacting.”

-Kirk Dando, Dando Advisors

Don't underestimate the complexity of integration.

Featuring Chad Elms, Former CEO, **Momentum Physical Therapy & Sports Rehab**

Integration can be the most difficult part of an inherently challenging process, says Chad Elms, who sold his physical therapy practice in 2015. "Knowing we were like-minded with our new partners, and sharing such similarities of culture and vision and all those things," Chad says, may have led him to assume the transition from two companies to one would be an easy one. "It has been really good for the most part, but we did underestimate the number of changes. Even though it was mostly for the better, it's still a change." In particular, Chad regrets the uncertainty the changes caused for his staff.

"What I would have done differently is to communicate more with our partner. There were some things in the fog of the changeover that fell through the cracks. We thought they were taking care of it, they thought we were taking care of it." A detailed calendar of dates and timelines and responsibilities would have allayed some of those concerns and made the transition more seamless for both sides.