M&A Preparation Tips for Businesses: Part 1 (Buyers Guide)

PUBLISHED ON
October 9, 2019

Most journalists don't have law degrees, so when they need help on a question we as attorneys have more experience in, we're always happy to help out.

As attorneys, we've been coached by those with journalism experience to always say too much in an interview, because a reporter always wants more than they need rather than less. A journalist also speaks to a number of different sources for a story, meaning two or three sources may say the same thing.

When a reporter from the *Central Penn Business Journal* recently interviewed us for the publication's annual *M&A in the Midstate* supplement, we were happy to be asked to contribute. But we also knew that CPBJ wouldn't have the ability to print every answer to every question posed to us. Left on the cutting room floor could be some valuable information that someone, somewhere, would find useful as they work to sell their business or buy another business.

So while CPBJ provided two very informative and helpful stories based on our answers, we wanted to also show what they didn't print from our answers in case it could be helpful to any of our clients.

If you have any questions on anything in these answers, please contact Paul Mattaini, Jeremy Frey or anyone in our Mergers & Acquisitions group.

Paul Mattaini answered questions for the article, "The Buyer Checklist," a guide for owners getting ready to purchase another business.

Central Penn Business Journal: Is it wise to buy a company with the goal of turning it around? Why or why not?

Paul Mattaini: I would be wary of a true "turnaround" unless a buyer specializes in those situations. Turnarounds require a special skillset, and often a new management team and possibly an entirely new business plan. However, there are situations in which a seller is confident that future performance will be better than historical performance. In those situations, it is possible that an "earnout" structure, where a portion of the purchase price is based on the post-closing performance of the business, might be attractive. These arrangements can be difficult to negotiate, but, if they are well-thought-out, they can work for both a buyer and a seller.

CPBJ: As a buyer, how can you tell from the outside if a company is worth the effort?

PM: The first step is often the receipt of information from a seller or its investment banker. This information is often in the form of a confidential information memorandum (CIM) and is shared with a prospective buyer after execution of a confidentiality agreement. Most potential buyers look at dozens of CIMs and decide not to pursue the opportunities further. However, if the CIM piques a buyer's interest, the next step is often the submission of an initial indication of interest (IOI). If the IOI is sufficient in the eyes of a seller, the buyer (and often a few others) are then afforded the opportunity to perform a full due diligence and submit a "refreshed" IOI. In some cases, buyers seek exclusivity or a "negotiated transaction" in which it has the opportunity to negotiate one-on-one with a seller. Some buyers will not participate in a structured process such as an auction. However, particularly at the higher levels, it is difficult to avoid such a process.

CPBJ: What should buyers look for in the due diligence phase?

PM: Most buyers will have a due diligence checklist it sends to a seller to identify topics/areas the buyer where wants to focus. The use of electronic data rooms in recent years has made the due diligence process easier and more secure. The disclosure schedules for the purchase agreement are an important, and difficult, part of the due diligence process. Buyers should be careful not to get too focused on its list and, instead, understand the business so the buyer can focus on the truly important aspects of the seller's business, the repetitive nature of the business' cash flow and key risk factors. One thing that has become popular is a quality of earnings report (Q of E) performed by an outside accounting firm. Q of E reports focus on the quality of the seller's earnings, such as the sustainability and accuracy of historical earnings as presented in the seller's financial statements and the achievability of any projections presented in the CIM. Some types of buyers, such as private equity firms, require a Q of E report in every transaction and, recently, financing sources for buyers are also requiring these reports as part of their due diligence.

CPBJ: As a buyer, what red flags tell you to steer clear of a deal?

PM: Some red flags that come to mind:

• If relationships are important to the business, it is often important for the owner(s) to remain with the business for an interim period after closing. If an owner is not willing to do so, it can be problematic.

• Lack of confidence in the management team.

• The culture is either objectively poor or incompatible with the culture of the buyer.

• Lack of opportunities for improvement in the financial performance of the business.

• Risks that cannot be controlled or even quantified.

CPBJ: What are the green flags that say go for it?

PM: It could be any number of items:

• The chance to achieve one or more of the goals of a buyer's acquisition program, such as a new product line, expansion of geographic markets, reaching a critical mass in terms of size, expansion of capacity or acquisition of additional management talent

• A strong management team. A seller can often assess management through management presentations and management interviews. If retaining current management is the intention, it is important to align the interests of the buyer and the management team through financial incentives for the latter

• A clear opportunity to improve the financial performance of the business, particularly if there is a well thought out plan to do so. Such a plan should include the amount of capital needed.

CPBJ: Any protections you should put in place to protect yourself as a buyer if you do take that leap?

PM: There is definitely a leap of faith that a buyer needs to take at some point to proceed with the acquisition. My experience is that entrepreneurs usually have pretty good judgment in this area, in terms of when to move forward and when not to do so. There are usually some protections in the purchase agreement for a buyer, in terms of indemnification for certain items. However, a buyer should never rely entirely on such protections if it has doubts about the seller's business. Research indicates that the biggest area in which buyers fall down is integrating the seller's business into the buyer's business/organization. For example, not enough buyers use the information obtained in the due diligence process in the integration process.

CPBJ: How important is company culture in the merger process?

PM: Culture is critical. However, it is difficult to discern culture in the due diligence process because of limited time and little or no access to the seller's workforce. A buyer may be able to assess culture to some degree through its access to the management team during the process and checking out web reviews of the seller. Also, to the extent that a buyer has access to the seller's suppliers and customers in the due diligence process, it may be possible to obtain some idea of the seller's culture.

In Part 2, Jeremy Frey talks M&A from the seller perspective.

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