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FIVE COMMON MISTAKES MADE BY BUYERS OF BUSINESSES

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It's common for investors and business owners to seek new companies to acquire. Sometimes they do it for strategic reasons – bringing a key supplier in-house or adding to existing production capacity by buying a company with similar capabilities. Other times they do it because they are business builders and want to expand their reach or take on new challenges. Or, in the case of an investor, they may simply have capital on hand and are looking for productive ways to invest it.

One might think that experienced business owners would know how to avoid common mistakes when looking to acquire a business. However, M&A is very nuanced and complicated before, during, and after a deal closes. Business owners often trust their instincts so much that sometimes they don't stop to ask the right questions, challenge their own assumptions, or make sure they have protected themselves against things that can go wrong.

We've all made mistakes. But for buyers of companies, such mistakes can be costly and hard to extricate themselves from. When we consult with clients interested in acquiring a business, there are five mistakes we help them avoid:

1. Overpaying for the Acquisition

There is a price that a company is worth to a seller. You know that if you go a little above that price, you have a much better chance of getting the owner to accept the offer, but too low and no deal. It makes sense to think ahead. For example, if you pay $10 million for a company today, you need to understand what the company needs to be worth in the future in order to get a good return on that investment. Is that $20 million, $30 million, or some other value?

The seller should have cash-flow projections that will help you calculate this and give you some idea of what kind of return to expect. Returns are a function of (a) the company's operations and the cash flows those operations will generate, and (b) the value paid for those cash flows. Let's say you want a 25% annualized return over five years. Depending on how much you pay, the projections should tell you if you can expect that kind of result. The more you pay, the lower the return. It is important to have a measuring stick to assess changes in projections, deal structure, and other pertinent factors.

So, what if you were considering offering $10 million but the projections tell you that the expected return only justifies a purchase price of $8 million? Buyers who are motivated to get a deal done might convince themselves that they can improve operations so much they'll get the return they need despite paying the higher price. But the objective data you have is telling you the correct price is a lower one. Buyers make a mistake when they ignore that data.

2. Limiting Due Diligence

When you're getting ready to invest millions of dollars in an enterprise, the question isn't what would you want to know about the company – but rather what wouldn't you want to know? No question seems out of bounds for a buyer getting ready to make that large an investment. Yet you'd be surprised how many buyers don't do enough due diligence. And some of the reasons might surprise you.

Most buyers, of course, look at the balance sheet and the profit/loss figures. But there is so much more beneath the surface. Does the company have any pending or potential litigation to deal with? Are there environmental violations? Problems with specific employees, the team as a whole, or HR issues? What kind of insurance does the company have? Are there areas where the company is underinsured? Did you check the machinery to make sure it's not too old and can still perform as you need it to? These are boring, check-the-box type issues. But they can cost you a lot of money if you neglect them.

Due diligence is a complicated proposition because you can only find out so much about the company before the offer is submitted. Once that happens, the company will disclose more information. But if that additional information suggests you offered too much, it can be tough to change the purchase price and still get the deal done.

A business owner who is acquiring another company in the same industry should be excellent at due diligence. If you make springs, for example, you should be the foremost expert on what you need to know about another spring company. Buying one of your vendors should also put you in a strong position to perform due diligence, and many business owners are interested in acquiring vendors – especially if they spend a significant amount of their money buying products or services from that company.

But remember: While similar, your vendor is not in exactly the same business you're in and has its own model for how to make money. You need to make sure you know how to run the company profitably, not just save money buying parts from an in-house company post-close.

A combination of impatience and arrogance sometimes leads prospective buyers to give due diligence short shrift. They just want to get the deal done already and they're sure they know what they need to know. However, it can be difficult to determine and identify all the issues and items that should be examined – you won't find out what you don't ask about. This is why due diligence is so essential.

3. Failing to Pay Attention to "Lightning Rod" Issues

After a seller works hard to market, strike a deal to sell, survive diligence, negotiate a purchase agreement's finer points, and get ready to close it can be very overwhelming for them to deal with "just one more" thing (or things) to finish up the transaction. Those items can include working capital, personal property leases, employment agreements, and other matters that don't normally get started until the diligence and purchase agreement are nearly done. This is a time in a deal when a seller is fatigued and ready to be done, but there is still "one more thing." The problem is that these issues are lightning rods for emotional responses from a seller.

If the seller owns the real estate, they have a personal attachment to it, its history, and most likely, the cash flow the owner enjoys from it. A buyer who looks to cut corners with a boiler plate lease structure or get the best deal on rent with the seller might be met with an angry reaction. The same goes for employment agreements with sellers who have presumably never worked under one, but are now subjected to definitions for cause, vacation periods, bonus language, severance, and other matters that are deeply personal. If you have counsel that grabs a form employment agreement off a shelf with terms that are too tough, get ready for a lightning strike.

Working capital is a double-edged sword for both buyer and seller. For example, let's imagine you're buying a business for $10 million and closing on June 30. But within a few weeks of closing, you realize the company pays bonuses at the end of every quarter, and $250,000 in payments are due in mid-July. There is $500,000 in the bank account, and the seller needs to leave $250,000 in the account for the bonuses. However, this becomes a touchy subject if the seller has been looking forward to walking away and taking all that money. That is just a cash-based example of a working capital adjustment, but all pieces of current assets and liabilities should be reviewed just as closely to ensure an adequate and fair level of working capital remains in the business.

While negotiations can break down over issues like this, cooler heads usually prevail, and everyone comes back to the table. However, don't underestimate the importance and timing of these lightning rod issues.

4. Not Securing the Leadership of the Company

One of the most important features of a strong company – the kind you would want to acquire – is a strong management team. A buyer needs to know that the management team is not only committed to sticking around but is on board with the purchase. New owners may choose to bring in some of their own people, but many times, at least initially after closing, it's better if to keep as much of the existing management team in place as possible. They might be replaced over time, but at the outset they likely know the ins and outs of running the company better than the new owner. Further, plans also need to be put in place to ensure that the second level of management of the company is retained, not just the C-suite.

This can be tricky. Transactions are often kept very quiet before they close, and there might be a limited number of people you can even talk to. But having the chance to speak with key management– not just to clue them in but to share your vision for the future of the company – is essential if you want to hit the ground running.

You'll want to meet the general manager, the sales manager, the plant manager, and other important employees. Your goal will be to meet as many people as possible and ensure that they come away from the meeting feeling excited about what you're planning to do as the new owner.

There are issues here. Sometimes you must ask members of the management team to sign non-compete and non-solicitation agreements. (These agreements ensure they must agree not to work for a competitor, and not to lure your other employees away.) Chances are they had no such agreement with the current owners, so you must lock them in and give them reasons to want to stay so they feel it's worth their while to agree to what you're asking.

Losing top management immediately after taking over a company can be a very big problem. Keeping them but not having them on board with your vision is nearly as much of a problem.

5. Biting Off Too Much, Too Quickly

Sometimes serial business builders can't help themselves and are constantly on the lookout for a new acquisition. Many acquisitions make sense, especially if they're manageable and add to a company's core competencies. If you're a $4 million company, it's one thing to purchase a $150,000 company – or even two or three. What if you purchase a $2 million company? That's 50 percent of your size. What if you purchase another $4 million company? That company is as big as yours, and most times, the larger the target the tougher the integration.

The people at the $150,000 company will understand they've been taken over by a much larger enterprise and will likely fall into line quickly with the buyer's way of doing things. However, the people at the $4 million company may say, in essence, "Hey! We're as big as you are. Why should we do things your way?"

Taking on too many acquisitions too quickly, or companies that are too big and difficult to manage, can prove to be a problem for the entrepreneur who badly wants the market share and capacity, but isn't necessarily ready to drive a successful integration process and manage the new business.

In Summary

Mistakes like these are avoidable. The most important thing is to have a plan. Do your due diligence. Secure the leadership. Make sure the working capital you'll need is available. Don't bite off more than you can chew. And take valuation seriously before agreeing to a purchase price.

I've encountered people so determined to deploy their capital that they've told me, "I'll buy anything." Don't do that. Be selective. You've earned the right to do that, after all. Find a company to buy that fits the profile of your existing business, and that adds value to it. If it doesn't fit strategy, you don't need to buy it and you shouldn't stretch.

Discipline on matters like these will pay off over time. And yes, even experienced business owners sometimes need to be reminded of these things. Those who listen are invariably thankful they did.

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About Charter

Founded in 1989, Charter Capital Partners is a premier investment banking firm headquartered in Grand Rapids, Michigan. We offer a comprehensive range of investment banking advisory services, including buy-side and sell-side M&A, succession planning, business valuation and capital raise.

About the Author

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Mike Palm has more than 18 years of finance and investing experience. He works on both advisory transactions and investment transactions for Charter.

As an investor, Mike oversees the Charter Growth Capital Fund L.P. as a member of the investment committee, completes fund advisory activities, and helps manage Charter's venture funds and other SPVs. As an advisor, Mike brings his years of private equity experience to help guide clients through M&A processes and the complex private equity landscape. He has partnered with and advised executives on both growth and recapitalization transactions.

Prior to joining Charter Capital Partners, Mike was a Vice President at Driehaus Private Equity, a Chicago-based private equity firm where he identified, reviewed, and executed investments in addition to providing oversight of the fund's portfolio investments. He joined the team as the firm's first employee outside the co-founders and is an advisor to the fund.

Mike spent three years as an Associate at Beecken Petty O'Keefe & Company, a middle market healthcare services investment firm in Chicago, where he focused on investments in the practice management, HCIT, insurance services, and medical products sectors. He began his career in the investment banking division of CRT Capital Group in Stamford, CT where he was a member of the healthcare, TMT, and restructuring teams.

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