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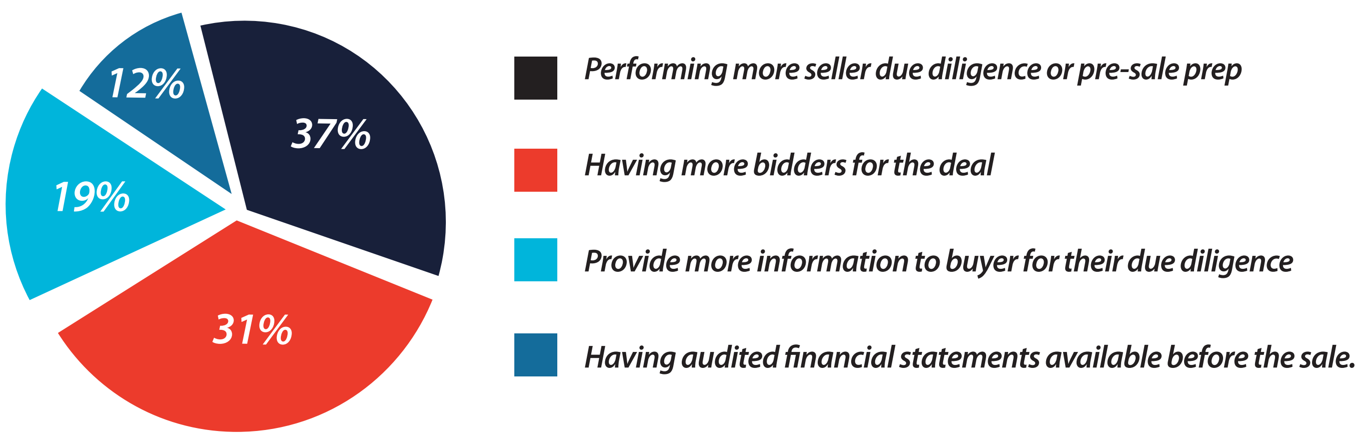
7 Top M&A Deal Killers and How to Avoid Them

- *David Ron and Kevin Scott, Centaur Partners*

Introduction

Maybe you've heard the saying that tech companies are generally bought, not sold. What this means is that you may have very little control over who acquires your company and, perhaps more importantly, when that acquisition takes place. Constant readiness then becomes imperative in order to both look attractive to potential buyers and to maximize the value of your company. Right now corporate America is holding over 2 trillion dollars in cash and is actively looking for productive ways to invest that capital. As of September, 498 IPOs had been registered in 2011. That's a ten-year high for IPOs. Every day buyers are combing through long lists of companies to acquire, so it pays to be aware of the steps you should be taking today to make sure you're ready tomorrow.

A mistake that's often made is making the assumption that due diligence is done only by entities looking to buy companies. In reality, comprehensive due diligence performed by you as the seller will not only make you look more attractive to potential buyers, but will also maximize the value of your company and expedite the transaction timeline.



Getting fully prepared for due diligence is best achieved by setting up a data room in advance and organizing all pertinent documents ahead of time. This best practice is not necessarily expensive – for example, ShareVault (the sponsor of this whitepaper), offers a solution called ShareVault Ever Ready – a low cost data room which provides the functionality you need during the preparation phase of due diligence, so that you can get started now, and then instantly upgrade to full due diligence capabilities when you need to.

Delays in the due diligence process have significant ramifications not only for deal value, but also for deal success. Remember that as a seller, time is not your friend. The more quickly the due diligence process moves along, the more likely it is that the transaction will be successful. The reality is that buyers walk away from over 50% of deals at some point during the due diligence process. Additionally, 85% of deals that do get done end up having a lower purchase price at closing than what was originally specified on the term sheet or letter of intent. Even after a deal is done there can be additional adjustments in price. 67% of the time escrow funds are tapped into after a deal is closed in order to adjust value. This is always a downward price adjustment. All of this exemplifies how crucial comprehensive seller due diligence is in order to attract potential buyers, maximize the value of the deal, and ensure deal success.

Today's buyer can be ruthless in evaluating your company's strengths and weaknesses. Many due diligence teams will attempt to steamroll you in order to expose risks and reduce value. How do you ensure that you've done all you can to look good in the face of this kind of scrutiny? Putting yourself in the buyer's shoes and anticipating what they will be looking for is the best way to ensure that your company will be ready when a buyer knocks on the door.

The bottom line is that the more you can do to be ready, the more likely that your deal will be successful and that you will maximize its value. Below are several areas of your company that will be scrutinized by a buyer and can potentially kill your deal.

The Most Common Factors that can Delay, Kill, or Reduce the Value of your Deal

Deal Killer #1 Failure to Validate Benefit to the Buyer

Can you provide the evidence to support the buyer's business case to buy your company? In all M&A deals there will be a sponsor at the buying company. Their job is to create a business case for buying your company and integrating it into the larger entity. If you don't understand what that business case is, and if you can't assist that internal sponsor in developing that case and presenting it to their support team then the deal will likely never get off the ground. One of the most important things you can do as a selling company is to understand your own value in the hands of a potential buyer. Why are they buying you? What are the synergies your company will bring to theirs? Understand the value that you are bringing to the table then be prepared to help the buyer articulate that value to himself and others.

CASE STUDY

Company A, a small tech company, wasn't generating a lot of revenue, however it had a very interesting technology that they knew Company B didn't have and would be interested in. The management team at Company A spent several weeks crafting the narrative of how their technology would enhance Company B's business model and increase market share. Because Company A's management team was aligned and could succinctly articulate and document the added value they would bring to Company B's business the deal went through at a higher value than Company A anticipated.

This is the most important hurdle to cross. If you can't validate the buyer's business case from the start and succinctly articulate how your business fits into it then the deal will likely falter. Take the time to ensure that your management team is informed, prepared and aligned.

Deal Killer #2 Failure to Prove Ownership of IP

Pick up the paper on any given day and you'll see an absolute swirl of litigation, claims, and counter claims surrounding the ownership of intellectual property.

The current patent war between Google, Microsoft and Apple, with each spending billions to build their respective mobile phone patent portfolios is an illustration of the importance of IP to acquisitive companies. Claims concerning the ownership of intellectual property are becoming both an offensive and defensive strategy for large technology buyers. Can you provide evidence that you own your intellectual property?

Often company executives are not aware of what's in their code base, what they own, what they don't own, what they have rights to transfer or not transfer, or what third-party technologies they are utilizing. Not having a firm grasp of your intellectual property can have serious ramifications on deal timing and deal success. Today the top technology acquirers will demand an audit of your code base to determine that everything in your code base is owned by you and that you have the right to transfer it.

The best practice here is to do an audit of your own code before someone else demands it, and then to put the resulting documents into your data room. If issues arise they can be remedied long before they can have disastrous effects on a deal.

Deal Killer #3 Unresolved Litigation

Are there any lawsuits or threats of litigation that could surface during the due diligence process? It should go without saying that threats of litigation are major red flags for buyers, however, it's not uncommon for the due diligence process to reveal litigation exposure that the owners of the selling company were not aware of. These exposures can be associated with ex-employees, past or present customers, vendors, intellectual property issues, and can even be related to company practices that are no longer in use.

Unresolved litigation will reduce deal value and should be dealt with well before a buyer shows interest. Once the due diligence process has started, unresolved litigation is much more difficult and costly to deal with and will delay and potentially kill a deal. Review unresolved and potential litigation with an attorney, put the relevant documents into your data room and resolve issues before they become factors in whether or not your company looks attractive to a buyer.

Deal Killer #4 Accounting Discrepancies

Can your company survive the scrutiny of a public company audit? If your company is acquired by a public company your company will be subjected to a public company audit. Any unidentified exposure in revenue recognition, booking, or deferred revenue practices will directly reduce your deal value at least dollar for dollar. Are your forecasts credible and consistent? Do you have any taxation issues? If you can't credibly present your financial picture to a potential buyer you throw your credibility into question, at best delaying a deal, at worst killing it. Accurate financial statements are central to determining value in a transaction. Buyers are expert at smoking out inaccuracies in your forecasts or reported financials and they'll take that out pound by pound from your transaction value. If your company has not had a recent audit, or ever had one, it's probably time to do it.

The quality of your accounting practices and of your ability to forecast will boost your credibility to a buyer and go a long way to minimize your risk in their eyes. Can you deliver a waterfall analysis that compares past forecasts to actual performance? This will provide the buyer evidence that you have produced reliable forecasts in the past and support the believability of your current forecast. However, risks that a buyer identifies may directly reduce your deal value in the form of a Purchase Price Adjustment. For instance, you may be asked to forecast your working capital balance at the projected closing date. If you under-forecast your working capital balance by a significant amount, then you can expect a dollar-for-dollar reduction in your price. If you have undisclosed liabilities (such as a sales commission or bonus that will be due on a post-close contract renewal) this amount may be deemed a Purchase Price Adjustment or maybe come out of escrow. Then there are always those Good Standing Certificates that you will have to get from each taxing jurisdiction where you conduct business. Are you current with all your tax jurisdictions and are there potential disputes that could either delay your deal or result in additional tax payments due that were not forecasted? Who is making your tax nexus decisions and are they being made in consultation with tax experts? Tax liabilities are one of the most frequent post closing price adjustments reported; often because of expedited nexus decisions made by private, selling companies. Can you provide support for your revenue recognition practices and will they meet the muster of a public company's scrutiny? You can assume that only the most conservative revenue recognition policies will be agreeable to a buyer. With regard to Deferred Revenue, if you were expecting that your Deferred Revenue would accrete to the buyer and add to your deal value, then you should rethink that and be prepared that as much as 50% to 80% of your Deferred Revenue may never be able to transfer to the buyer and therefore may not be considered in the deal value equation.

Deal Killer #5 Company Agreements Exposures and Risks

One of the scary realizations you may experience when attempting to sell a company is that buyers will require you to produce all of your company agreements entered into from the very first day you started doing business. These could be vendor agreements, customer agreements, employee agreements, or any other type of agreement you've entered into. They'll be interested to see if they're all signed and that you're not in default or out of compliance with any of them. It's important to take a complete inventory of these agreements and ensure that nothing is missing, incomplete, or inaccurate. In particular, buyers will be looking for any non standard terms and conditions, such as exclusivity, or source code escrows, or unusual support or product obligations, or termination rights, or the non-assignment or cancellation of a contract. If there's value associated with a contract and it's not transferable that will be of interest to the buyer and potentially reduce the value of the deal. If an assignment is in question and you have to go back and get consent, it will cause delays in the transaction, and frankly, it reflects poorly on management and your company's credibility when you have to scramble around to find documents during the due diligence process. Inventory your company agreements now, identify any non standard terms, make sure they're all accounted for and signed, and upload them to a virtual data room so they're there when a buyer wants to see them.

Deal Killer #6 Corporate Governance Exposures and Risks

When a buyer scrutinizes your company they'll want to know how the processes, customs, policies, laws, and institutions of your company impact how your company is controlled. They'll want to know the nature and extent of the accountability of the participants in the business as well as the relationships among the stakeholders and the goals by which the company is governed.

Have all of your company's securities and stock issuances been properly issued and authorized? Are board meeting minutes available for review? Are management, investors and the Board of Directors in agreement on distribution of proceeds? Have 409A valuations been performed by reliable sources? Are all of the critical corporate documents in your virtual data room?

When Corporate Governance policies are incomplete or sloppy it causes delays in the due diligence process and is costly to tidy up. Do it ahead of time. Make sure everything is complete and available for review in a virtual data room

CASE STUDY

In 2008 a large investment company decided to sell 20 of its companies. In April they set up a virtual data room and began organizing due diligence documents, but it took until July to locate all the pertinent documents and get them organized for review. By the time they had an auction and had a buyer lined up it was September and by then the economy had shifted and it was the worst time to try to sell anything. The transaction didn't close until December and the seller took a significant hit in valuation because they were selling at a bad time in the market. In retrospect, the seller realized that there might have been a much different outcome to the deal if they'd been ready with the data room earlier.

Deal Killer #7 HR and Employee Exposure and Risks

When a buyer looks at your company they'll want to know who your employees are and they will want to examine all the employee agreements. Of particular interest will be any change in control terms that affect stock vesting, severance or compensation. They'll want to know about key employees and not only whether they're planning to stay with the new company, but also whether any employment terms will change. Key employees are typically central to the deal and the announcement that a key employee is leaving may impact your deal value. If key employees leave after the deal is completed it can reduce escrow or their own individual holdbacks.

Before considering a sale, ensure that all your employee records and contracts are in order, current, signed and organized in a virtual data room for review. It's of particular importance to ensure that proprietary rights agreements are current and in order. If there are proprietary rights agreements that apply to ex-employees and they are not current or in order, tracking down those ex-employees in the midst of the due diligence process can be a nightmare. In addition, you should be sure that you have all your current and ex-employee and shareholder addresses. Nothing is more

more frustrating then delaying the deal because you cannot locate an ex-employee to gain their signature on a consent or document that should have been signed years ago.

CASE STUDY

When a major technology company was audited it was discovered that over a thousand of what they had designated as "contractors" were actually, according to the courts, "employees." The company not only had to pay those individuals compensation and penalties, but they also had to settle with authorities for 35 million dollars.

Conclusion

Today's buyers are ruthless when it comes to due diligence, so it's imperative when entering into a potential transaction to be organized, thorough, and to ensure that nothing the buyer might be interested in seeing is inaccurate or missing. Start by putting yourself in the shoes of the buyer and do an honest self-assessment of your company. Are there any glaring red flags? Would you be impressed if you were the buyer? Secondly, know a potential buyer's business case and be prepared to articulate exactly how your business will add value to theirs.

Setup a virtual data room right away, so that it can be activated quickly when you are approached by a potential buyer. ShareVault Ever Ready is the ideal platform for transaction readiness, and its so affordable that there's really no reason not to put it in place right now.

Being prepared and ready can make the difference between a good deal and a great deal or even a deal that goes through versus one that dies. Don't wait. Your company should always operate as if a buyer is right around the corner.

What to look for in a Virtual Data Room:

- An entirely web-based application that does not require installation of additional software
- Fast, intuitive platform, enabling ease of use and the ability to customize for individual applications
- Security protocol that allows tracking of documents even after they've been downloaded
- Instant full-text search, so that users can quickly find the information they need
- Per-user and per-document control settings to manage who can see what information and when
- Policy-based rights management to control who has the right to view, print or save each document
- The ability to apply watermarks, block screen shots, prevent copy/paste and retroactively revoke rights to open documents, even if they have already been downloaded
- Comprehensive reporting tools which provide information on who has viewed what documents
- Compatible with both Mac and PC platforms.
- 24/7 customer support including a remote screen-sharing capability so that support staff can view the issue live on the user's screen
- Bank-grade security and reliability with a SAS-70 type 2 certified data center, dual redundant servers, data encryption and comprehensive security protocol

About the Authors

CENTAUR PARTNERS

David Ron and Kevin Scott lead the transaction readiness practice at Centaur Partners, a business development consultancy focused on technology companies in the software, communications, semiconductor and clean tech market sectors.

David Ron

David Ron has 20 years' experience as a CFO, leading venture-backed technology companies through their business life cycles and creating value for their shareholders. David has directly led or advised board of directors and management teams, both as a CFO and as a consultant on numerous complex financial transactions, including M&A transactions (sale of companies to Microsoft and IBM), VC financings (over $120 million raised in more than 14 rounds), an IPO (Metaphor) and complex deal and customer agreement negotiations.

Prior to Centaur Partners, David was the CFO of Market6, a software/information service that improves supply chain efficiencies for consumer packaged goods companies. At Market6, he raised over $26 million in VC funding and venture debt. While at Rapt, as VP of Finance, he assisted in the transformation of this software company from supply chain optimization for the manufacturing sector to become the leading price optimization technology used in online advertising. In addition, Mr. Ron was a co-founder and CFO for Global Sight and TV Interactive.

David received a B.S.B.A. in Business Administration and International Management from Boston University (cum laude) and earned his M.B.A. from Suffolk University.

Kevin Scott

Kevin has a 15+ year track record of achievement across financial operations, M&A, venture capital and secondary investing, and portfolio management. As a partner at PwC, Kevin advised small private as well as Fortune 50 companies on M&A strategy, process and execution. He took a lead role in developing and scaling a $50M merger integration practice across the US and to Europe. At 3i Venture Capital, Kevin led/co-led investments in 15 technology businesses. As a Board member on these investments, he demonstrated expertise in CEO recruitment, compensation issues, financing negotiation, growth strategy, and profitable exit management. Kevin successfully spun out 12 portfolio companies from 3i in a secondary transaction to create Maywood Capital Partners in 2009.

Kevin received an MBA in management policy and finance from the Kellogg Graduate School of Management at Northwestern University. He graduated from the University of California, Berkeley with a BA in Political Economics.

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