The Number One Cause of M&A Deal Failures

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I believe one of the biggest reasons for M&A deals blowing up is a poorly worded Letter of Intent. The standard process is to solicit offers from buyers in the form of Letters of Intent (LOI). The terms and conditions are negotiated until one winner emerges and the seller and buyer dual sign the LOI which is non-binding. This basically gives either party an out should something be discovered in the due diligence process that is not to their liking or is not as presented in the initial materials.

When I say poorly worded, what I really should have said is that it is worded much to the advantage of the buyer and gives them a lot of wiggle room in how the letter is interpreted and translated into the definitive purchase agreement. The best comparison I can make is a lease agreement for an apartment. It is so one-sided in favor of the landlord and protects him from every conceivable problem with the renter.

Business buyers are usually very experienced and the sellers are generally first time sellers. The buyers have probably learned some important and costly lessons from past deals and vow never to let that happen again. This is often reflected in their LOI. They also count on several dynamics from the process that are in their favor. Their deal team is experienced and is at the ready to claim that "this is a standard deal practice" or "this is the calculation according to GAAP accounting rules". They count on the seller suffering from deal fatigue after the numerous conference calls, corporate visits, and the arduous production of due diligence information.

When the LOI is then translated into the Definitive Purchase Agreement by the buyer's team, any term that is open for interpretation will be interpreted in favor of the buyer and conversely to the detriment of the seller. The seller can try to fight each point, and usually there are several attacks on the original value detailed in the dual signed LOI that took the seller off the market for 45-60 days. The buyer and his team of experts will fight each deal term from the dispassionate standpoint on one evaluating several deals simultaneously. The seller, on the other hand, is fully emotionally committed to the result of his life's work. He is at a decided negotiating disadvantage.

The unfortunate result of this process is that the seller usually caves on most items and sacrifices a significant portion of the value that he thought he would realize from the sale. More often than not, however, the seller interprets this activity by the buyer as acting in bad faith and simply blows up the deal, only to return to the market as damaged goods. The implied message when we reconnect with previous interested buyers after going into due diligence is that the buyers found some dirty laundry in the process. These previously interested buyers may jump back in, but they generally jump back in at a transaction value lower that what they were originally willing to pay.

How do we stop this unfortunate buyer advantage and subsequent bad behavior? The first and most important thing we can do is to convey the message that there are several interested and qualified buyers that are very close in the process. If we are doing our job properly, we will be conveying an accurate version of the reality of the deal. The message is that we have many good options and if you try to behave badly, we will simply cut you off and reach out to our next best choices. The second thing we can do is to negotiate the wording in the Letter of Intent to be very precise and not allow room for interpretation that can attack the value and terms we originally intended. We will show a couple examples of LOI deal points as written by the buyer (with lots of room for interpretation) and we will counter those with examples of precise language that protects the seller.

Buyer's Earnout Language:

The amount will be paid using the following formula:

-75% of the value will be paid at closing

-The remaining 25% will be held as retention by the BUYERs to be paid in 2 equal installments at the 12 month and 24 month anniversaries, based on the following formula and with the goal of retaining at least 95% of the TTM revenue. In case at the 12 and 24 month anniversaries the TTM revenue falls below 95%, the retention amount will be adjusted based on the percentage retained. For example, if 90% of the TTM revenue is retained at 12 months, the retention value will be adjusted to 90% of the original value. In case the revenue retention falls at or below 80%, the retention value will be adjusted to $0.

Earnout Language Seller Counter Proposal

The amount will be paid using the following formula:

> -75% of the value will be paid at closing
> -The remaining 25% will be held as Earnout by the BUYERs to be paid in 4 equal installments at the 6, 12, 18 and 24 months anniversaries, based on the following formula:
>
> We will set a 5% per year revenue growth target for two years as a way for Sellers to receive 100% of their Earnout (categorized as "additional transaction value" for contract and tax purposes).
>
> So, for example, the trailing 12 months revenues for the period above for purposes of this example are $2,355,000. For a 5% growth rate in year one, the resulting target is $2,415,000 for year 1 and $2,535,750 in year 2. The combined revenue target for the two years post acquisition is $4,950,750.

Based on a purchase price of $2,355,430, the 25% earnout would be valued at par at $588,857. We can simply back into an earnout payout rate by dividing the par value target of $588,857 by the total targeted revenues of $4.95 MM.

The result is a payout rate of 11.89% of the first two years' revenue. If SELLER falls short of the target they fall short in the payout, if they exceed the amount, they earn a payout premium. Below are two examples of performance:

Example 1 is the combined 2 years' revenues total $4.50 MM - the resulting 2 year payout would be $535,244.

Example 2 is the combined 2 years' revenues total $5.50 MM - the resulting 2 year payout would be $654,187.

Comparison and Comments: The buyer's language contained a severe penalty if revenues dropped below 80% of prior levels, the earnout payment goes to $0. Also they have only a penalty for falling short and no corresponding reward for exceeding expectations. The seller's counter proposal is very specific, formula driven and uses examples. It will be very hard to misinterpret this language. The seller's language accounts for the punishment of a shortfall with the upside reward of exceeding growth projections. The principle of both proposals is the same - to protect and grow revenue, but the results for the seller are far superior with the counter proposal language.

Buyer's Working Capital Example:

This proposal assumes a cash free, debt free balance sheet and a normalized level of working capital at closing.

Seller's Working Capital Counter Proposal:

At or around closing the respective accounting teams will do an analysis of accounts payable and accounts receivable. The seller will retain all receivables in excess of payables plus all cash and cash equivalents. The balance sheet will be assumed by the buyer with a $0 net working capital balance.

Comparison and Comments: The buyer's language is vague and not specific and is a problem waiting to happen. So for example, if the buyer's experts decide that a "normalized level of working capital at closing is a surplus of $400,000, the value of the transaction to the seller dropped by $400,000 compared to the seller's counter proposal language. The objective in seller negotiations is to truly understand the value of the various offers before countersigning the LOI. For example, an offer for cash at closing of $4,000,000 with the seller retaining all excess net working capital when the normal level is $800,000 is superior to an offer for $4.4 million with working capital levels retained at normal levels.

These are two very important deal terms and they can move the effective transaction value by large amounts if they are allowed to be loosely worded in the letter of intent and then interpreted to the buyer's advantage in translation to the definitive purchase agreement. Why not just cut off that option with very precise and specific language in the LOI with formulas and examples prior to execution by the seller. The chances of the deal going through to closing will rise dramatically with this relatively easy to execute negotiation element.