Don’t Even Think ‘Merger’ Without Taking These 5 Steps First

What was supposed to be a sunny $2 billion acquisition of U.S. television manufacturer Vizio by Chinese company LeEco went south when the latter had trouble coming up with the money. The deal reportedly included a $100 million fee should LeEco terminate the agreement, prompting Vizio to file a lawsuit.

Vizio alleges that LeEco executives deliberately misrepresented the company’s financial situation and used the merger to obtain confidential information. The situation between Vizio and LeEco seems particularly volatile, but it’s not unusual for mergers to go belly-up once both parties gain access to each other’s books.

While numerous companies attempt to journey through the mazelike jungle of mergers and acquisitions, Harvard Business Review reports that 70-90 percent of those attempts end in failure. The terms of mergers can be complex, but experienced business leaders should learn to recognize the red flags that indicate they might be headed into a tumultuous situation.

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Doing your due diligence.

Selling your company — or buying one — involves digging up the skeletons of a poorly managed balanced sheet. In the earliest stages of a startup, it’s not uncommon for entrepreneurs to have a somewhat cavalier attitude. They might loan themselves money or use a company credit card for personal expenses. These decisions can come back to haunt companies when someone

digs into their financials.

Any companies involved in a merger should have spotless balance sheets. Both parties should be in good standing with the Internal Revenue Service, with updated tax information, sound legal documents and completed I-9s for all employees.

In instances where a public company is acquiring a smaller company that will comprise a substantial portion of the new body, all financials must comply with U.S. Securities and Exchange Commission disclosure requirements. Revising financials to this standard can take weeks, so it’s a good idea to plan ahead.

It’s equally important to allow plenty of time for due diligence. Even if you have the legal, compliance and tax knowledge necessary to navigate the process, it often takes much longer to complete than anticipated. It’s exhausting, but unexpected surprises can derail the entire agreement if both sides don’t exercise due diligence before the deal closes.

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There are plenty of ways for mergers to fall through, but not all are destined for failure. To prevent any last-minute meltdowns, follow these steps to get everything in order:

1. Clean up your balance sheet.

Your company’s assets, liabilities and equity shouldn’t contain any line items that you aren’t comfortable discussing. Be ready to explain everything to potential buyers and illustrate the earning potential of your business.

CB Insights has conducted research that indicates that 29 percent of startups fail because they run out of money. Yours isn’t one of them, but your balance sheet needs to provide

plenty of transparency regarding your financial position.

2. Update your capitalization table, and prepare it for pro forma analyses.

This step is important for your company and potential investors. A capitalization table can indicate how much you'll be diluted in certain situations – such as if an acquiring company issues more shares. A report by Capshare found that company founders typically own far less of their company than they think.

Work to get your cap table as organized as possible, clarifying everything from various classes of stock and options to warrants. Whatever format you take – there is no "right way" to organize your cap table – be sure to include stockholder names, date of issuance, the number of shares owned, type of shares owned, date of disposition and some high-level commentary.

3. Have a sell-side due diligence team dive into your numbers.

A buy-side diligence team will dig into all details and scrutinize every last penny of your bottom line. Instead of being blindsided, hire a sell-side team to run your numbers and give you a chance to fix mistakes before buyers find them.

This might be as simple as cleaning up your customer database. If you don't have a standard naming convention for your customers, a quick outside analysis might indicate a heavily inflated churn rate rather than inconsistent naming.

Be sure to look beyond numbers, too. One of the biggest issues in the mergers and acquisitions world, according to a survey

by Morrison & Foerster, is unrelated to financials – 82 percent of respondents said cybersecurity is a major concern. It's much easier to fix mistakes ahead of time than it is to explain the situation to an exasperated and unsympathetic buyer at the last minute.

4. Make sure your data room can be updated.

An online data room – also known as a virtual data room – is a storehouse for your key information and documents. Critical documents such as contracts, financial statements, employee data and intellectual property information should all be housed in your data room, making the due diligence process as efficient as possible. The market revenue for virtual data rooms has ballooned to more than $800 million, underscoring the growing demand for this capability.

At the same time, the odds of you finding a buyer, signing a letter of intent, blazing through due diligence and closing in the same calendar month is next to impossible. As additional months of data are created during negotiations, you'll need to make that information available. Make it easier on your team by using an online data room that can be continuously populated with information as needed.

5. Create a timeline of priorities and responsibilities for due diligence.

Before you begin the due diligence process, do some self-diligence. Examine your contracts for any change of control provisions, which can make acquiring your company less valuable for a buyer.

When you pass over control of a company, it can trigger certain agreed-upon rights – maybe you're required to pay out employee bonuses, or key suppliers might retain the right to renegotiate the terms of their contracts. Research by Meridian Compensation Partners found that about 75 percent of 160 companies involved in one study include cash severance for named executive officers in their change of control provisions. Be aware of any provisions and transparent about them throughout the process.

It's also important to shop around when you're debating selling your company. If you're approached out of the blue, take a moment and analyze the market. Your board members can prove a valuable resource in this instance because they have a fiduciary responsibility to get your shareholders the best deal possible.

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The due diligence process is not for the faint of heart. It's long and drawn out, and some major issues might not bubble up to the surface until late in the process. Be thorough, but realize that time truly does kill all deals – whether it's the loss of negotiating power or simply lost interest from a buyer.

In spite of all the due diligence in the world, merging with a company inherently carries some level of risk. Once you've had the opportunity to fully vet any deals and negotiate, you have to decide whether the reward is worth the risk.

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