# Business Buyer Protection Report®

Issue 100

**The Business Buyer Advocate®**

Showing People How to Buy the Right Business the Right Way

## Street-smart tips to help you avoid pitfalls when buying or selling a business

# Demystifying Pre-LOI Due Diligence

*You're reading a transcript from a Zoominar, plus coverage of other, related, topics.*

*This report highlights many of the most important issues. Listen to this series of podcasts for details: Let's Demystify Pre-LOI Diligence. They go beyond this report.*

**Hello, I'm Ted Leverette**, The Original *Business Buyer Advocate* ®. I'm not a business broker; never have been. For more than 30 years, over 100,000 entrepreneurs and advisors, worldwide, have relied upon my books and trainings to creatively finance, buy or sell small and midsize businesses. I've privately coached more than 1,000 clients. And, I've trained 298 independent advisors, so they can better-serve people buying and selling businesses.

**Listen** to what Searcher **Dan Precourt** shares with us about Pre-LOI Due Diligence.

### So, you want to buy a business, or sell your company?

Your fun (and your risk) begins during your *preliminary* interactions with the other side of your dealmaking table. It's called preliminary due diligence. Where buyers and sellers want know, right now, whether it's smart or not to exchange information.

It's touchy. And most people don't know what to do about it.

Preliminary due diligence is *not* for do-it-yourselfers, unless they want to undermine their opportunities. What I cover today can be your launchpad to collaborate with your advisors; it's what the *savviest* buyers do.

### Let's *Demystify* Pre-LOI Due Diligence

Defective pre-LOI due diligence enables dumb deals.

- It's why so many searchers cannot make a deal, or they buy the wrong businesses, or they buy the right businesses the wrong ways.
- It's also why hopeful owners lose their opportunity to sell, or they sell on terms that excessively favor buyers.

Way more important, than digging too deeply in preliminary financial diligence, is addressing the nonfinancial factors, and knowing how to organize and manage preliminary diligence. If you don't get right the nonfinancial issues, the financials won't matter.

### What lessons are in the Elon Musk fiasco with Twitter?

Don't shoot yourself in the foot. Or the company you might want to buy. Especially, intentionally.

The really good news is Elon Musk has shown us nearly **all** of the most damaging behaviors a wannabe acquirer can make. **77** blunders! No kidding. Google to see my LinkedIn article: *"Fractured Fairy Tale – Musk and Twitter?"*

## *Key Takeaways*

*If you don't get this right, you can taint your entire marketplace. Few people will want to respond to you except owners of lousy businesses hoping for a greater fool to take their loser off their hands.*

### When (and how) does *preliminary* diligence begin?

With the first words you express or hear with business owners and sellers, and anyone representing them. It's your earliest opportunity to asses your risk and value.

Begin with your endgame in mind.

### What's the purpose of *preliminary* due diligence?

To cut to the chase. Is this buyer or seller worth pursuing?

Besides not knowing how and when to conduct *preliminary* diligence, ill-informed and ill-advised searchers and sellers mostly miss the point of it:

- Get the parties to the dealmaking table, or abort the potential transaction
- safely and sooner.

Nancy Fallon-Houle (Corporate, Securities, M&A Lawyer) says: "Walk away if basic legal due diligence doesn't pan out." Such as examining the name and ownership of the entity being sold and its status. Are all the assets being sold owned by that legal entity? What about intellectual property assets? Employment agreements? Who can approve or deny the potential transaction? Review the Corporate Articles of Incorporation or the LLC Articles of Organization (and, their Amendments). "That's the bare minimum before the LOI."

*The pricing multiple relates to the degree of risk and opportunity.*

- *Your multiple is applied to whatever value indicator you're using.*
- *Such as SDE, EBITDA, pre- or after-tax profit, etc.*

*The multiple and the value indicator are not static.*

### Why is *preliminary* diligence so important?

Because it's better to find out what you're buying before you buy it.

If you want to *sell* your business, you cannot afford to expose yourself to unworthy wannabes, especially unprepared or ill-advised searchers.

You're going to have to zero in on the *drivers* of business valuation.

The first thing most *sellers* look at in LOIs is what is says about *pricing* the company for sale, perhaps the valuation rationale.

Is it expressed in a range? Or take-it-or leave it? Is there a methodology for adjusting the offering price on the basis of what the *seller* told you during pre-LOI due diligence and what you discover during your investigations?

BTW, this is probably the most touchy issue. It craters potential deals. You and your advisory team had better be adept at reasonably defining how the price is derived and open for modification.

You're going to have to handle it with kid gloves.

*Advisors facilitate you making a worthwhile deal, and to help you avoid bad deals.*

Speaking of touchy issues. Here's another one:

The scope and time for diligence. Pre-LOI diligence and later during formal diligence.

David Barnett (Small Business and Deal Making SME): "There's a big difference between the amount of time it takes to gather preliminary information from sellers represented by qualified business brokers versus independently sourced deals where the sellers are unprepared."

**Nancy Fallon-Houle:** Let sellers know that you have more due diligence questions for after the LOI. Tell sellers you're simply gathering important information to test the probable worthiness of a potential transaction. To submit an LOI as soon as possible.

### How do the drivers of preliminary diligence differ for searchers?

Preliminary diligence is when the boilerplate checklists shoot searchers in the feet. Begin with and dig deeper on what's most important to you. Later, *formal* due diligence is where you get to learn nearly everything you're going to need to know to assess your opportunity.

**Nancy Fallon-Houle:** What about business due diligence that affects legal? If you're buying customer accounts, poke into those first, from the seller's company records, evaluating the soundness of them. Are they real? Note that Elon Musk learned late in the Twitter deal that Twitter could not confirm how many accounts are bots or unverified. Musk was buying the Twitter accounts; first, he should have checked into that key fact.

### How deep is enough/too much for pre-LOI diligence?

Gather the minimum amount of pertinent information necessary to submit a well-crafted letter of intent, or to abort the opportunity. "Pertinent" is the keyword.

**Nancy Fallon-Houle:** "Include a sentence in your LOI that the offer your making may be adjusted based upon the results of due diligence. (And, yes, you can change your offer after the LOI.)"

### What about if buyer competition is present?

You might have to outbid the most ignorant buyers.

One of the most important things I do with my clients is help them avoid or beat buyer competition. We do it, *upfront*, by creating a winning marketing plan for searching and finding the kinds of businesses we want to buy.

Tip: Instead, of offering sellers yes/no choices, get conversations going about "how about this or how about that?"

Sellers and brokers are usually right when they think buyers are like buses; more will be by soon. That's why it's smart to invest *considerable* effort in relationship building with brokers and sellers.

**David Barnett** talks about buyer competition; why it arises and what to do about it. You'll find that and other topics in our series: Let's Demystify Pre-LOI Diligence.

### What's the *optimum* timing before aborting or submitting my LOI?

Well, how much time should elapse during preliminary diligence**?** It depends on the motivation of the buyer and seller. Which is *bigly* affected by the degree of buyer competition. And whether a business broker is orchestrating the process.

### What goes wrong during pre-LOI due diligence?

The top things that I see are people getting too analytical, investing too much time before making an offer, then negotiating against themselves, i.e. trying to pre-determine how sellers will react and changing offers before actually giving the seller a chance to see/react to their offer.

Whatever you do, or the other side of the dealmaking table does, that shouldn't be done . . . can stifle your opportunity. Such as:

- Overdoing it. Underdoing it.

Not getting a reading on the *expectations* of the seller and buyer. What's their respective scope, timing and desired outcome? Get agreement before proceeding. (This relates to what I said earlier: Pay attention to and nourish the nonfinancial factors.)

Think of it like peeling an onion. Begin with communications that help build rapport while revealing information. Defer touchy issues.

Peeling an onion? It's rarely a good idea to hand brokers and sellers your master list of questions and demands. Most sellers don't have to put up with it, and they'll substitute another buyer for you. And, it's not only the *quantity* of your request; it's the *depth* you seek on some of the issues. There are about a dozen must-ask questions to probe, but *not* too deeply for most of them. Beware of people who tell you there's a perfect question list or checklist. There isn't.

What happens in any kind of diligence is unique to the particular kind of companies and transactions, and the people involved.

As for *underdoing* it, if you fail to probe some of the most important issues, you can end up spending time and money crafting an LOI, that sellers eagerly sign . . . Because they love your error or your omission, which gives them negotiating advantages.

An example of this is not understanding valuation drivers, and loading your LOI with terms that favor the seller.

Good luck trying to change them during formal due diligence and negotiation of your buy/sell contract.

**David Barnett:** "A buyer's greatest resource is actually their time. I've come to this conclusion after meeting buyers who spent years looking for businesses." Window-shopping wastes time and money.


***More Resources***

*Subscribe to free e-Newsletter*

*YouTube channel:*
*How to Buy the Right Business the Right Way*

*2-Minute Video:*
*What the Savviest Searchers Do to Find and Buy the Right Businesses the Right Way*

*Schedule*
*an hour of coaching with*
*Ted Leverette.*

*Searcher and Search Evaluation*

### How do buyers and sellers go wrong?

They misconstrue *pre*-LOI diligence to simply mean fact-finding, so as to determine whether or not a deal might be possible.

- More astute people realize what's really happening. They're setting the stage, they're prepping for negotiations and dealmaking.
- And that's how *they*, upfront, begin to get negotiating advantages.

### What if the seller or bank demands my personal guarantee?

Consider whether your opportunity makes it worthwhile.

And, know the various ways to negotiate the personal guarantee.

A CPA shares: "How to Limit Risks on Personal Guarantee Business Loans."

### What if the seller won't partially finance the buyer?

Look to creative financing.

Here's an example of the kind of creative financing that is possible for lots of opportunities: Business Acquisition Creative Financing—After Gaining Control.

You can get 499 other ideas by downloading my book, How To Get All The Money You Want For Your Business Without Stealing It.

### What if the price buyers propose is not justified *after* the LOI?

This comes up a lot. Before your LOI, you think the business is worth X. During formal due diligence you find out it's not.

Not too many owners like giving up what they saw as their opportunity. This is why a well-crafted LOI can enable further negotiations on price and terms.

**Tip**: The *pricing multiple* relates to the degree of risk and opportunity.

Your multiple is applied to whatever *value indicator* you're using. Such as SDE, EBITDA, pre- or after-tax profit, etc.

The multiple and the value indicator *are not static*. That's why it's a good idea to discuss this *pre*-LOI with brokers, sellers, and everyone else on your dealmaking playing field.

Get this wrong (like most buyers do) and you risk buying the *wrong* business, or buying the *right* business on the *wrong* terms.

Or, having sellers reject your LOI. So . . .

- What's your basis, rationale, for challenging the seller's view of the business' history and future?

**David Barnett:** "A basic thing people can do pre-LOI is to know some of the industry benchmarks." Ask: "How is it that your X differs so much from industry metrics?" Speaking to comparative facts can ground people in reality.

### Can I change my LOI offer?

Sure. But the other side doesn't have to accept it. Knowing what you need to know before your LOI is *why* you conduct *preliminary* diligence. Your letter of intent either opens the door or it shuts off your opportunity to modify terms of the LOI, while, later, you're drafting the definitive purchase and sale agreement.

### What are the roles of my advisory team during pre-LOI diligence?

To *facilitate* you making a worthwhile deal, and to help you avoid bad deals. A big problem, however, is when you bring in your specialist too early or too late.

Most importantly, not to screw up. I see too many searchers and their advisory teams stepping on each others feet. Some people aren't good team players. Some simply don't know enough about what happens during *pre*-LOI due diligence.

As for brokers and other kinds of intermediaries, representing sellers: They are not on the buyer's team. Encourage them to help you *facilitate* your deal, but primarily look to your own team for guidance.

One of the most important things I do with my clients is to help them manage their specialists. This can save buyers and sellers lots of time and money. And aggravation.

### What are the considerations for outsourcing due diligence?

Make sure you see examples, in detail, for the scope and contents of the kind of due diligence you need to do. There are quite a few so-called experts out there who simply have read a few books about due diligence, or maybe only a few online articles, so they can spew the jargon, the buzzwords, hoping to impress naïve searchers and business sellers.

**Tip**: Stage it. First, do what you can on your own. Outsource only the elements you cannot reliably handle.

You'll deplete too much of your dealmaking money if you try to outsource too much, especially on multiple opportunities.

Even when you stage your efforts, be aware that it may be necessary to outsource it to a credible third party.

An example is when your investors require it as a condition of funding your deal.

Lenders, too, might require it if they're not comfortable with your efforts.

Something else to consider: What will it cost you if your due diligence is not enough?

### How has the pandemic affected preliminary due diligence?

It's caused some of us to pay more attention to what's likely to be losing propositions. Wasting time and money doesn't pay. Move on if you don't get what you want.

### How email (especially Gmail) hurts buyers, sellers, brokers, etc.

Spam filters don't like the kinds of text in emails concerning business opportunities and buy/sell transactions. Gmail is one of the worst perpetrators; it spams what is not spam. And doesn't make it easy for you to know what's not been seen.

You may not get a chance for preliminary due diligence if you use Gmail or if you don't properly format your email.

**Don't let this happen to you:**

1. A searcher, whose LOI was signed, lost the deal to another buyer (thanks to an unseen Gmail).
2. [Business Broker] I have this problem too. I get an angry phone call asking why I haven't replied to their email. My first question: "Is it a Gmail account?" It is.
3. "Thanks Ted. Just replying to your email to take you out of my spam folder."

Don't use Gmail.

In a private session I can explain more about this, and how to beat it. (Google snoops–no privacy. Sees your contacts.)

### How am I supposed to know what the seller wants to see in my LOI?

Ask. It's a good idea to know what somebody wants before you propose what you think they want. Isn't it?

### How do brokers and sellers view self-funded buyers versus search funds?

It's all about the money. Whoever shows it first gets the advantage.

There aren't too many brokers and sellers wanting to go through due diligence at least twice, which is what happens for most search funds who let the searcher handle the first round of diligence, and then the investors want it done again for themselves. Self-funders can have huge advantages, if they properly deploy at the right times the right kinds of advisors.

*Corum Mergers & Acquisitions* published, online, an eye-opening article: "Search Funds - The Good, The Bad, and The Ugly."

### What should buyers *and* sellers do *before* pre-LOI diligence?

Learn how to do it. Including, what to avoid. And hire an expert to prepare you and then guide you through it.

Don't eagerly hire "experts" who tell you they know enough. Run from people who won't show you written information that is *exactly* what they've done and can do for you. There are a lot of poseurs out there pitching services for people wanting to buy and sell small and midsize businesses. Don't let them risk your life and money. (One of my most important roles with buyers is helping them screen, hire and manage specialists.)

Sellers:

- Exit Planning.
- Pre-sale planning.
- Pre-sale due diligence.

Buyers:

- Learn how to market yourself to brokers and sellers, and how to productively search and quickly screen opportunities.

Deploy the best practices from my books, available from Amazon:

How to Prepare Yourself and Find the Right Business to Buy

How to Buy the Right Business the Right Way—Dos, Don'ts & Profit Strategies

### ***If*** **it's a good idea to do it, how should a searcher introduce creative deal structure . . . pre-LOI?**

Yes, it's a good idea to brainstorm with sellers various ways your deal could be structured. Don't be assertive about them, but use your ideas to show sellers that you're thinking creatively and looking for alternatives to complete a deal.

Pay attention to the seller's reactions: You're seeing the degree to which they're going to help make a deal. The take-it-or-leave-it tactic is not smart.

### How can I level the buy/sell playing field? (Broker/seller advantages?)

First, understand what it is. Here's a pictorial I use with clients.

The playing field is tilted against buyers.

You cannot achieve the best deal possible if you play on an un-level field.

<u>Here's why sellers start with advantages:</u>

1. They *know more* about their company and industry than you, and few will tell you everything;
2. They have *prepared* themselves and their company for sale;
3. *They think* there are a lot of buyers for it (which is often true);
4. They have an *advisory team*. And *maybe a business broker* represents them.

### How do buyers/sellers negotiate against themselves?

By offering concessions without being asked. By mishandling the interactions among the people on the playing field.

When searchers portray themselves as better than they are. Sellers do it in their CIMs, which undermines their credibility with buyers from moment one.

### What kinds of vulnerabilities can be fatal?

Misbehavior on the part of buyers and sellers craters what could be wonderful done deals.

Not understanding the truth about post-completion after-tax net cash flow.

Too many buyers, for example, ignorantly think they'll pay acquisition debt with pre-tax dollars.

### What about (flexing) working capital?

I like that word: Flexing. Working capital *is* flexible. It's *changing* while you're examining the business, and it changes immediately after you buy or sell the company.

It's a good idea for your letter of intent to anticipate this.

### What about employees, customers, suppliers, sources of financing?

They know the truth about the business. The sooner you get information from them, the more secure you can be as you proceed during your evaluation and dealmaking.

### How deeply should I probe, anticipating seller Representations and Warranties?

Your legal counsel can tell you what are probably going to be the reps and warranties for the kind and size of deal you want to do, in the industries you're targeting.

Get a reading on this during pre-LOI due diligence.

### How much do I collaborate with sellers/brokers about the pending LOI?

The sooner and better your collaboration, the less your confrontation. Preliminary due diligence is where you build the bridge toward your intended deal.

If you handle it right, talking about alternatives, and the rationales, it can help you reach a meeting of the minds. You increase your risk, of the seller aborting you, if you simply present your LOI, without earlier discussing the issues.

### How can I use the LOI to make a better deal?

Buyers use the LOI to motivate sellers to want to do a deal with that buyer. The more sellers want you, the buyer, the more the seller will do to help you buy the company.

Save the negativities and contention for negotiations, which happens *after* formal due diligence.

### What do brokers think about pre-LOI due diligence?

It depends on the broker. Some brokers want you to sign a purchase agreement that has a couple of escape classes. Others invite pre-LOI due diligence, because this is when they can learn whether or not you're a worthy buyer.

### What is a reasonable budget for professional fees?

It's been said that you cannot pay too much for good advice or pay too little for terrible advice. It's the height of wishful thinking to try to buy a business without having the right kind of advisory team in place before you begin searching for opportunities.

Knowing how to deploy your team is essential. As for the budget, simply ask lawyers accountants, and others, to specify what they want to earn for whatever scope of work you need. Get details on this.

### Where can I get a checklist?

This might be where your risk grows. Using boilerplate checklists is not smart. They must be crafted for the kind, size, location and other factors, pertaining to you and your target company, and the kind of deal you envision.

Tip: Experts you're paying to help you are most likely to give you reasonable checklists. And they'll show you how to use them, like peeling an onion. Only the most foolish buyers and sellers go to the Internet and download checklists. Or use checklists that might have worked for somebody, but may not work for searchers given their *particular* circumstances.

### How am I supposed to cope with the abundance of documents, communications, etc.?

It's like drinking from a firehose. For everyone on all sides of the dealmaking table.

Establish an online deal room or data room. But be sure you ask your advisory team what venue they like to use. Otherwise, you get to pay them to learn whatever you foist upon them.

### What if I cannot afford paying to outsource due diligence?

Do it yourself. But do it yourself with expert guidance. My business buying books show you what's worked for my clients for decades. The books contain best practices by people successfully buying and selling small and midsize businesses.

**Okay, folks, that's it for now.**

I hope you'll **Zoom** with me, so I can help you find and buy the right businesses the right way.

**Oh, and one more thing . . .**

You can find and complete better deals if you deploy the best practices from my books:

How to Prepare Yourself and Find the Right Business to Buy

How to Buy the Right Business the Right Way

How to Get ALL the Money You Want For Your Business Without Stealing It

You can get them on Amazon, and from my website.

And, you can subscribe to my free monthly e-newsletter. That's partneroncall.com

So . . . I'm Ted Leverette, the Business Buyer Advocate with "Partner" On-Call Network.

Thanks for reading this.

(Be careful out there.)

# And . . . that's not all.

**Consider the view of brokers and sellers:**

Dave Kauppi, Merger and Acquisition Advisor with Mid Market Capital, Inc.
From his e-Newsletter: If you are a business seller, one of the most challenging aspects of the sale process is listening to a potential buyer tell you why your baby is not beautiful. It is hard not to take that personally.

These positioning statements by buyers often are interpreted as personal attacks or insensitive comments by someone that doesn't get it. Managing this process often is critical to maintaining a good buyer/seller relationship and creating an environment where a deal is possible.

Know the questions and answers that can help the potential buyer really understand the seller's business, and understand any issues that could impact the business in the future. The second not-so-subtle message is that we really understand the flaws in your company and we are going to manage your expectations and justify our less than generous offer.

That is OK. Do they expect us to take this lying down? Two can play at that game, or whatever cliché we can think of. But, we must counter punch and our defense generally takes the form of answers that either explain why a negative was a one-time occurrence or something we have already identified and have taken corrective action. Our second major counter to the negatives from the buyer is to demonstrate that we understand why they are an interested buyer in the first place and try to position our company as a strategic acquisition.

You may be asking yourself, does this actually do any good? Well, it depends. If they have the feeling that they are the only buyer in the process and we are selling the company from a position of weakness, our counter efforts are largely ineffective. If, however, they have the impression that the aforementioned Competitor A, Competitor B, and Competitor C have been presented the same positioning and have bought into one or two of the strategic arguments, then it really does work.

We try to send back our own not so subtle message. We know what we have. We understand the market and the competition. We understand the strategic implications of you or one of your competitors in control of our product line. We have other options besides you, so you might have to alter your expectations on how much you are willing to pay to become the ultimate buyer. Plus, this helps our seller feel less like a punching bag and more like a worthy opponent.

**There's more!**


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## Tips from Ted Leverette

Sellers and their advisors do *not* tell buyers enough of what buyers need to know to make informed decisions about buying or investing in companies.

And neither will any of your *individual* advisors. You need a team to safely and profitably buy or sell a small or midsize business.

You must effectively participate on your team, such as gathering how-to information on your own.

What you don’t know you don’t know can hurt.

Buyer competition forces some acquirers to make fatal concessions when negotiating with sellers.

- That's why so many people buy the right businesses the wrong ways.
- Or, they have to settle for what other searchers don't want.

The easiest and best way to avoid buying a loser is to get access to lots of winners, especially while avoiding buyer competition.

**Let’s Zoom** if you’re not sure you know everything you need to know, so you can safely and profitably proceed.

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