Business Advisor and Dealmaker Testimonies: Deficiencies in Privately Held Small Businesses Leading to Failed M&A Transactions

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Abstract:
Like running a company, the business exit process is complex and filled with uncertain outcomes. Some individuals start a business without much thought of an eventual exit while others enter with a goal in mind, an exit strategy from the onset. Even with a planned strategy, circumstances affecting business owners such as life situations (like retirement, health, family, time commitments, relocation, or burnout), strategic opportunities (like harvest, divestiture, growth, or turnaround situations), and other owner interests (both business or non-business related) outside of the company frequently arise while macroeconomic issues may interject potentially altering exit outcomes. Unfortunately, only a small percentage of businesses listed for sale eventually sell. This article provides insight to business owners and advisors on what major deficiencies exist which lead to unsuccessful ownership transfers of privately-held companies. To gain this insight, a study was conducted with business advisors and dealmakers who engage with small business owners in helping them sell their companies. This qualitative analysis involved coding the responses of 50 seasoned certified business intermediaries and exit advisors with median advisory experience of 15 years working with small business owners in the transition of their companies. These consultants responded to open-ended questions related to past experiences. Five central themes of deficiencies leading to unconsummated transactions were uncovered through the analysis: Problems associated with the business financials, management issues, operational issues, customer issues, and the lack of business owners understanding the selling process.

Keywords:
selling a business, M&A, exit planning, business consulting, business for sale, entrepreneurial exit

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Business Advisor and Dealmaker Testimonies: **Deficiencies in Privately Held Small Businesses Leading to Failed M&A Transactions**

By Kipp A. Krukowski, PhD, ASA, CVA

As a shock to many locals, an iconic Cleveland business, Corky & Lenny's, closed its doors in December 2023. The owner, responding to a journalist's question about seeking a buyer to purchase the business, replied that her co-owner husband (Kenny) was

> running into a wall or just sort of breaking down energetically. Kenny is a machine running the business and while we do have employees, he really takes on the responsibility of making sure that everything gets done. ... He just felt like he probably should have done this over a year ago, for his own physical, mental, and emotional well-being. It is sad to see the business close. [We're] still making money. ... We had a number of [possible buyers and partners] for the business. A variety of different kinds of deals. They all fell through for one reason or another.[1]

This gut-wrenching response likely hits home to many business owners and advisors; a decent business shuttering operations due to a failed attempt at an M&A transaction.

Like running a business, the exit process is complex and filled with uncertain outcomes.[2] Some people start a business without much thought of an eventual exit, while others enter with a goal in mind; an exit strategy from the outset.[3] Even with a planned strategy, circumstances affecting business owners frequently arise, such as life situations (e.g., retirement, health, family, time commitments, relocation, or burnout), strategic opportunities (e.g., harvest, divestiture, growth, or turnaround situations), and other owner interests outside the company (both business- and nonbusiness-related).[4] In addition, macroeconomic issues may alter exit outcomes.[5]

Business owners and their advisors face an uphill battle when it comes to successfully transferring a company to new ownership. "According to the International Business Brokers Association and *Forbes*, only 10% of businesses listed for sale eventually sell."[6] But why is this statistic so low? This article helps to uncover this mystery, providing business owners and advisors with insight into major deficiencies that can lead to unsuccessful ownership transfers of privately held companies.

To gain this insight, a study was constructed to get answers directly from the source: business advisors and dealmakers on the front lines working with small business owners to help them sell their businesses. This research followed a grounded theory methodology,[7] which allows survey participants to provide responses related to their experiences. As a qualitative inquiry, findings are exploratory. Using this approach, theory is grounded in field data, from the bottom up, making sense of phenomena through rigorous coding and interpretation procedures. Focusing on the core research question of what deficiencies lead to unsuccessful business exits when attempting to sell a company to an unaffiliated individual or company, this qualitative analysis involved coding the responses of 50 seasoned certified business intermediaries and exit planners, with median advisory experience of 15 years, working with small business owners in the transition of their companies. Participants were asked open-ended questions about small business deficiencies—as well as value creation strategies (to be discussed in future articles)—and were paid $50 each for their thorough participation in the study. The median time spent answering the questions was 40 minutes per participant.

To capture their unique experiences accurately, participants replied in their own words and these answers were captured within Qualtrics, a surveying tool used by researchers. Data was then coded outside of Qualtrics, removing any personal identification. Each of the 50 business advisors was assigned a number, coded as BA01–BA50, tied to their specific responses. In some cases, responses that covered multiple deficiencies were assigned to multiple themes. Through the analysis, five core deficiency themes emerged that led to unconsummated transactions:

- Business financials
- Management issues
- Operational issues
- Customer issues
- Lack of understanding of the selling process

1 Peter Chakerian and Paris Wolfe, "Corky and Lenny's Co-owner Amanda Kurland: Here's Why We Closed the Restaurant," *Cleveland.com*, December 13, 2023, https://www.cleveland.com/entertainment/2023/12/corky-and-lennys-co-owner-amanda-kurland-heres-why-we-closed-the-restaurant.html

2 Karl Wennberg and Dawn R. DeTienne, "What Do We Really Mean When We Talk about 'Exit'? A Critical Review of Research on Entrepreneurial Exit," *International Small Business Journal* 32, no. 1 (2014): 4–16.

3 Dawn R. DeTienne and Melissa S. Cardon, "Impact of Founder Experience on Exit Intentions," *Small Business Economics* 38 (2012): 351–374.

4 Kipp A. Krukowski, Nicole A. Flink, and Bryan D. Edwards, "Why Are You Selling Your Business? Understanding Signaling Effects of Seller Rationale at Time of Entrepreneurial Exit," *Journal of Business Venturing Insights* 20 (November 2023): e00427.

5 Kipp A. Krukowski and Dawn R. DeTienne,"Selling a Business After the Pandemic? How Crisis and Information Asymmetry Affect Deal Terms," *Business Horizons* 65, no. 5 (September–October 2022): 617–630.

6 Arnez Rodriguez, "Business Brokers in the US," *IBISWorld Industry Report* OD4796 (2021).

7 Barney Glaser and Anselm Strauss, *The Discovery of Grounded Theory: Strategies for Qualitative Research* (Abingdon, U.K.: Routledge, 2017).

Business Financials

One central business deficiency theme related to poor business financial records. Business advisors pointed out that owners' lack of understanding of their financial status and the absence of good books and records (e.g., miscategorized expenses), make it difficult to communicate actual performance, leading potential buyers to take a more cautious approach to an acquisition. Other advisors commented that personal expenses are often commingled with business expenses, making it difficult to separate the two. Part of the problem, one advisor [BA33] noted, is that "main street business owners are typically handling bookkeeping themselves," leading to delays in financial activities, such as due diligence and loan evaluations, because information is not readily available. Other advisors echoed similar concerns, observing that many owners do not know their businesses' "financials, key ratios, performance against goals, profit margins, etc." [BA47]. This lack of financial literacy and poor recordkeeping makes it difficult to accurately value and position the business for sale. Not only are potential acquirers turned off by poor financials, but business advisors may be turned off as well. As one advisor [BA50] stated, "Perhaps the single biggest initial challenge is qualifying who prepares their financial statements." This same advisor followed this up by stating, "I have walked away from potential assignments as an appraiser and business broker, not feeling confident in the financial materials I was reviewing." In summary, the lack of solid financial management and proper recordkeeping is a significant barrier to the successful sale of a business.

Responses Categorized under Financial Deficiencies

- Personal expenses commingled with business expenses
- Low margins
- Charging below-market rent when facility is owned by the seller
- Absence of properly prepared financial statements and records, either intentionally or through ignorance
- Lack of consistent financial performance
- Inconsistent or miscategorized expenses in the financial statements
- Failure to maintain financial statements on a monthly or even quarterly basis
- Failure to prepare current year-to-date financial statements with all expense items
- Owner's salary not segregated out from general payroll account for identifying owner benefits
- Declining revenues and profitability as an owner has taken his or her eye off the ball
- Poorly assembled financials violating basic accounting rules
- Poor grasp of future revenue and profit projections
- Financial statements, tax returns, leases, and other corporate documents not readily available
- Lack of advanced planning to minimize discretionary expenses categorized in a way not accepted by potential acquirers or lenders
- Leases that have expired, are month-to-month, or are based on a handshake agreement between the landlord and seller

- Failure to pass along cost increases to customers
- Financial statements and tax returns that do not easily tie with one another
- Poor accounting and recordkeeping systems
- Financial statements that are not structured with enough revenue and expense breakdown to assist in managing the business
- Financial statements that are structured and designed to minimize operating profit for tax purposes
- Lack of understanding of the appropriate level of working capital needed for operations
- Too many personal expense adjustments in the financials
- Unreported cash receipts in an effort to minimize taxes
- Inaccurate (or lack of) balance sheet
- Official financial results delayed due to filing for tax extensions
- Owners that have a poor understanding of financials and business metrics
- Lack of reinvestment into the growth of the business

Management Issues

Another key deficiency relates to the centralization of responsibilities and knowledge around the owners, making the business overly dependent on them. One business advisor talked about owners wearing "too many hats" and failing to delegate duties. The owner was too integral to the day-to-day operations to make it easy for a new owner to step in. Another advisor highlighted the challenges in transferring critical functions and knowledge as owners are "often uniquely gifted and suited for the business, making the transfer of those skills and relationships very challenging" [BA03]. While this uniqueness might create a competitive advantage while owning and operating the business, at the time of exit a potential buyer must be convinced that the business will retain these attributes.

Some business advisors pointed out that there is often an absence of middle management and poor organization of staff and resources. This overreliance on the owner makes the business too dependent on one person, hindering its ability to operate independently. Similarly, as one advisor observed, a large percentage of sales is often driven by owners, making them irreplaceable. Excessive dependence on the owner for key business operations and decisions creates a significant challenge in transitioning the business to a new owner, and potential buyers find this obstacle difficult to overcome.

Responses Categorized under Management Deficiencies

- Lack of organizational structure and senior management outside of the owner
- Critical functions, relationships, and know-how are centered on the owner, who is often uniquely gifted and suited for the business, making the transfer very challenging
- Dependency on an owner who is too involved in day-to-day operations and decision-making
- Owner reluctance to make needed personnel adjustments to avoid conflict
- Owner suffering from "fatigue" accompanied by a lack of drive to continue the business forward
- Lack of a mix of tenured, cross-trained employees
- Key employees retiring at the same time
- Insufficient human resource documentation of individual employee growth and future plans
- Ownership strong in one aspect of the business but lacking in other expertise and know-how to supplement their weaknesses
- High staff turnover
- Owner is the "face of the business"
- No exit strategy
- Failure to delegate responsibilities
- Unwillingness or inability to transfer key knowledge, skills, and relationships to key employees
- Lost focus on the business
- Failure to continually review business performance to identify problems and opportunities
- Unwillingness to take advice from others

Excessive dependence on the owner for key business operations and decisions creates a significant challenge in transitioning the business to a new owner, and potential buyers find this obstacle difficult to overcome.

Operational Issues

Business advisors pointed out that operations often suffer from a lack of documented systems and processes. As one advisor observed, there are often "no real systems for running the business (i.e., operations manual, organizational chart, etc.) that can be passed on to a new owner. Everything is in the seller's head, which makes transitions sometimes more difficult than they have to be" [BA33]. Several advisors noted that the absence of key systems (e.g., customer relationship management [CRM], enterprise resource planning [ERP], and accounting), policies, and procedures make for a difficult sale. Others raised concerns about excess and obsolete inventory due to lack of controls. In addition, lack of personnel documentation, such as employee manuals and job descriptions, make it more challenging for potential buyers to gain comfort in what will remain after a transaction. Poor operational documentation can also lead to excess or obsolete equipment and inventory, as well as poor maintenance and disorganized facilities. This deficiency theme underscores the importance of having well-documented, organized operational processes for a business to be attractive to potential buyers.

Responses Categorized under Operational Deficiencies

- Key systems and processes not documented
- Inadequate (or lack of) CRM, ERP, point of sale (POS), or accounting systems
- No documented policies or procedures
- Inaccurate inventory counts and value
- Excess or obsolete inventory
- Excess equipment not needed for existing or projected future requirements
- No employee job descriptions and manuals
- Unresolved legal issues
- Poor cleanliness, maintenance, and organization of facilities
- High reliance on employee skills instead of documented systems
- Short history of operations
- Old facility or equipment
- Questionable facility suitability
- Uncertain supplier relations
- High dependency on (and lack of) available workforce for growth
- High vendor concentration and dependency
- Lack of a forward-looking business plan

Customer Issues

Customer concentration is a significant issue for many small businesses. As one business advisor observed, the risk of having "a disproportionate share of business generated by one key customer/client" [BA03] can be a red flag to potential acquirers. Customer issues may go beyond high concentration. For example, job shops and project-based work without contracts create uncertainty regarding future revenue streams. Also, declining revenues or lack of growth in the customer base are signs of weakness that may cause concern to potential acquirers. This theme illustrates the risks associated with high concentration and uncertainty, which can make the business less appealing to potential buyers due to perceived instability.

Responses Categorized under Customer-Related Deficiencies

- Disproportionate share of business generated by a few customers
- Owners' relaxed marketing efforts to obtain new customers
- Business is primarily a job shop or project-based without recurring revenues or contracts
- Dated (or nonexistent) internet and social media presence
- Lack of revenue growth or growth in the customer base

Lack of Understanding of the Selling Process

The selling process is often hindered by unrealistic seller expectations. One business advisor mentioned the challenges of finding a successor with a similar skillset. In niche industries, which often tend to be more profitable than fragmented industries, the potential buyer pool is even narrower. Frequently, one advisor observed, owners are "ready to sell but the business is not [in a position to sell] and they are not receptive to making the changes necessary to unlock the highest level of value" [BA05]. The most frequent response was that business owners often have unrealistic price expectations and lack an understanding of business valuation in general. This can be concerning because even if a potential buyer is identified, a misinformed seller may reject a reasonable offer and negotiations may never lead to a transaction. If sellers initially hold off in hopes of receiving a better offer, eventual price adjustments may be too late; potential buyers may have moved on to other opportunities.

Another business advisor highlighted the importance of trust, noting that "both buyer and seller [need] to trust each other to get the deal done" [BA07]. Timing is also important, and unfortunately owners often wait too long to sell. Waiting too long may leave no option but to close the business, similar to what happened to Corky & Lenny's. Advisors also revealed that some owners mentally check out before a buyer is identified. The result, one advisor commented, "is that they back off of marketing and sales, or perhaps unconsciously back away from the hard work to keep the business growing. The result can be a decline in sales and profitability and that leads to less interest on the part of buyers" [BA47]. When revenue begins to decline, buyers become more skeptical that issues might be larger than they appear, and that revenue is poised for a freefall.

Many business owners lack a good grasp of the due diligence process and how experienced advisors, attorneys, and accountants play a crucial role in negotiating and facilitating a transaction. Planning and preparation can help ensure that all stakeholders are on the same page and the business is prepared to hit the market. This theme underscores the importance of realistic expectations of value and the selling process. The process often takes an extended period of time, and business owners should continue running the business without letting up.

Responses Categorized under Lack of Understanding of the Selling Process

- Unrealistic price/value expectations based on actual results of operations
- Unfamiliarity with the time required to find a buyer and to complete all the steps required to consummate a transaction
- Lack of understanding of all the documents and information buyers will require during due diligence
- Confusion regarding business valuation and value drivers
- Underappreciation of the importance of experienced advisors, attorneys, and accountants in the process
- Lack of agreement among stakeholders to pursue a sale of the business
- Lack of preparation in putting the business on the market
- Lack of tax planning

Some Closing Optimism

Selling a small business is a challenge. The statistics show that there is a strong probability that a small business owner will not make it to the closing table. While this article will not magically change the outcome of all failed transactions, understanding the deficiencies that often exist in small businesses is the first step toward identifying potential solutions that can improve the odds of a successful exit.

As this article highlights, there is an opportunity for advisors to better position business owners in advance of M&A transactions. Future articles will examine business models to identify value creation opportunities and explore strategies business advisors and owners can use to improve transactional success. VE

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