Five Signs That Your Merger Is Doomed

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You should never pursue an acquisition deal unless the background legwork comes up perfectly clean. The reason is simple: anything that smells slightly fishy before the acquisition is likely to become toxic afterwards. Here are five red flags you must heed when you're checking out the bona fides of a merger candidate.

Red Flag #1: Most of the target firm's revenues come from a business you don't understand.

Why It's Red: The acquisition may have no coherent connection to your corporate strategy. If so, it's unlikely that you'll understand how to operate the acquired firm effectively, because the rules for operating in that market will remain foreign to you.

Quote: "Back in the '80s there was this diversification craze and everybody was just buying anything that looked like it was making money. In most cases, they had no idea how to run the acquired company — other than run it into the ground."

— Edward Weiss, of Bregman, Berbert, Schwartz, and Gilday, and former general counsel for Group 1 Software, Inc., which acquired several firms and was later acquired itself by Pitney Bowes.

Red Flag #2: The target firm has a radically different corporate culture.

Why It's Red: Integrating one company into another typically involves reassignments, layoffs, and relocations — all of which are difficult to manage. On top of that, you don't want the added confusion caused by clashing management styles and differing ideas about how business should be conducted.

Quote: "Merging organizations with incompatible ideas about how to do business always creates major problems. The different factions resist each other strenuously but not always explicitly, so it can be extremely complex to untangle the people issues."

— Richard Caro, CEO of Tangible Future, a San Francisco consulting firm that helps companies grow.

Red Flag #3: A sudden, positive change in the target's recent revenue or inventory.

Why It's Red: The data might reflect a one-time event rather than a sustainable change in the target's ongoing business. Worst case, it might be an attempt to increase the valuation of the target firm by making it seem more attractive than it actually is.

Quote: "You need to look at the deal holistically; anything out of the ordinary is cause to drill down and find out the straight story. For example, if the revenue spiked up last year, it might be because of a one-time big sale. If the inventory changes suddenly for no apparent reason, they may have been understating their inventory in the past to look more efficient."

— Rocco Pezza, president of the New England Brokerage Corporation, which advises small to mid-sized businesses on mergers, acquisitions, and financing.

Red Flag #4: The target's management seems desperate to go forward.

Why It's Red: Ideally, you want to acquire a firm that has strong enough fundamentals to be successful on its own. If the management is acutely anxious to make a deal, it may be because they secretly hope you'll rescue them from the consequences of their own shortcomings.

Quote: "You can build a company that's ripe to be bought, but you can't build a company that's meant to be sold. If the managers in the target firm are anxious to be bought, it's probably because they don't have the top-line growth, cost control, or management skills to make it on their own."

— Jack Cooper, president and CEO of consulting firm JM Cooper & Associates, and former CIO at Bristol-Myers Squibb and Seagram, where he participated in several successful mergers.

Red Flag #5: The buyout will create instant millionaires out of employees who hold founder's stock.

Why It's Red: You're not just acquiring a company, you're acquiring the people who know how that company works. If key personnel will become rich on the deal, there's a good chance they'll jump ship shortly after the deal is completed, leaving you with an empty shell.

Quote: "We don't want to create gazillionaires. If we're talking about a purchase price that's going to make [the target company] millionaires, we always force them to take an earn-out. They get some money up front, but not enough to take off and retire."

— Dennis Weldon, director of corporate development and investor relations at Mentor Graphics Corporation and former corporate controller for First Farwest Transportation and Financial, a company built principally through a series of acquisitions.

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