Acquisition War Story: Sandbagging Salaries

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ACQUISITION WAR STORIES

Hi Julia,

Our War Story **last month explored the relationship between the seller and their management team. This time, we're turning to how that relationship impacts salaries at the company you want to buy. What happens if the current salaries are below market?**

After reading the story, let me know your thoughts!

Enjoy,

Elliott Holland
Managing Director
Guardian Due Diligence
(404) 441-2637
Connect on LinkedIn

Sandbagging Salaries

One of our clients was considering a business with a management team that had been around and working with each other for a long time. The management team was planning to stay with the business after the sale. We start the Quality of Earnings process, and we notice that the salaries of this veteran management team aren't representative of their experience level. The buyer wasn't initially worried about this detail. As long as the team was planning to stay with the business and wanted to continue working for their current salaries, he figured that they weren't relevant to the deal.

The main reason lower-than-expected salaries matter is that you can't reasonably expect an employee to continue working for a salary below the market rate for any long period of time. You probably won't get the backstory or rationale behind why salaries weren't raised or why a management team didn't demand higher salaries under the old regime. They may have had a longstanding relationship with the seller or were getting bonuses or equity kickers. This all means that you've inherited an employee or employees who might need to be replaced in the near future. That would require drastically increasing your cash outlay to get someone of a similar experience level and skill set.

In this case, the five-member management team had understated their salaries by around $300,000. During our diligence process, we told the client that replacing them would cost them another $300,000. As a new owner, you just don't want to be in a position where an executive team member leaves—which is already a challenging situation—to then realize that you need to find an equal replacement at twice the cost.

We brought this issue up with the seller, and they didn't have a good answer. He beat around the bush. It ended up being an issue that the buyer took back to the seller, along with some other items found in diligence, to negotiate a lower purchase price.

The lesson here is to consider the salaries of the management team against what it might cost you to replace them. You can't necessarily trust that the people will stay, and you need to manage your cash flow so that you can pay the bank back for the debt that you took on.

White Paper: 12 Other Critical Questions to Ask Before Buying a Business

Your diligence process shouldn't stop at financials. Plenty of other aspects of a business will influence your purchase price and future expectations for success. Check out the essential follow-up to our 13 Financial Questions to Ask Before Buying a Business.

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We Stop You From Buying a Bad Business

Guardian Due Diligence was founded in 2017 to provide market-leading due diligence and deal advisory solutions to acquisition entrepreneurs, ETA entrepreneurs, and deal professionals. We provide more than just a Quality of Earnings. Our due diligence services come with a layer of expert deal advisory to help you through valuations, LOIs & negotiations with sellers and brokers. The principals of Guardian have been in the industry since 2009 and bring that experience to our clients. We provide all the solutions inside one firm. We bring the best-vetted resources to your deal in a cost-effective way that adds tremendous value.

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