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Getting M&A Deals Done Despite Frozen Credit Markets

The current freeze in the credit markets has hammered M&A deal making. I've had several acquisition transactions recently terminate because buyers couldn't line up financing. Lenders are spooked, which has forced buyers to be much more cautious. No buyer wants to commit to a transaction it may not be able to finance.

Yet the challenging financing markets are presenting opportunities to those buyers who can finance deals. Fort Worth based Ancor Capital Partners is one of the few private equity firms in the market that has recently successfully financed and purchased two companies. In the midst of the financial meltdown in October 2008 Ancor closed on the purchase of Care Options for Kids and in December 2008 it closed on the purchase of TomCat Bakery. "While the financing markets remain challenging, if you have a proven track record, can add value to a transaction and are creative in the capital structure there are deals that can get done in this market", said Brook Smith, Managing Director at Ancor. He continued, "in spite of the today's economic environment Ancor continues to selectively pursue acquisitions and uses a variety of capital structures in our deals."

So what are the alternatives to traditional bank financing? Here are some financing options buyers are currently using:

Subordinated, or mezzanine, financing. This type of financing sits below senior debt in the capital structure yet above the equity capitalization. It can have features of both debt and equity, including scheduled repayment dates and equity conversion rights or warrants. This type of financing structure is most helpful when a bank is unwilling to completely fund the gap between the total purchase price and the amount of equity a buyer is willing to kick into the deal. This was the preferred capital structure utilized by Ancor in each of the two transactions they recently closed.

Seller paper. This method of financing is increasing in popularity, especially in smaller transactions involving private sellers. A seller promissory note may also offer tax advantages if the seller can recognize gain from the sale over several tax years as it receives the note payments. Seller financing will typically be subordinated to any senior debt the buyer incurs and subject to the rights of the senior lender, so the seller will have to pay close attention to the terms of any intercreditor agreement with the senior lender.

Earnouts. An earnout is a contingent purchase price payment to be made after the closing; the amount of the payment depends on the performance of the purchased business. Earnouts can be tricky to negotiate and draft and are more prone to disputes. The buyer will control the business after the closing, and the seller might later object to the buyer's decisions that have a negative effect on the earnout payments. Therefore, sellers tend to favor earnouts that are simple to calculate and less prone to dispute, such as earnouts based on revenues, while buyers typically favor earnouts that are based on cash flow, net income or some financial measure that's farther down the income statement. Long story short, it pays to retain an experienced lawyer and accountant to help evaluate earnout proposals.

Use equity now, refinance with debt later. A handful of private equity firms are taking this approach when they spot a "can't miss" opportunity. This financing alternative can offer a buyer a huge advantage when bank financing is extremely difficult to obtain - for example, where the seller lacks hard assets to serve as collateral or has a commodity goods inventory that fluctuates wildly in value that understandably makes a bank skittish.

These buyers are typically sitting on piles of cash they can use to finance most or all of the purchase price in equity. Later, when debt financing becomes available on reasonable terms, they'll layer debt on the company and perhaps take some money off the table in a dividend recapitalization.

Loan to own. This financing technique has become a financing staple for troubled companies. The lender will fund the loan knowing there's a substantial chance that the borrower won't be able to repay it. But that's no problem; the lender will be more than happy to foreclose and run the business itself. While some may view these types of transactions as onerous, they often give a company a last-ditch opportunity to turn things around.

Bridge financing. This temporary financing is designed to "bridge" the seller to the closing of the acquisition transaction and is increasingly being used for those companies that experience cash flow or liquidity problems after the deal is signed. There are obvious risks to the buyer if the deal doesn't close, so it has mainly been used to rescue deals where catastrophic, unanticipated cash flow issues have arisen after the parties already have a signed deal.

Industry financing. This alternative can sometimes be available when an industry partner is the buyer or where the buyer is a private equity firm with a portfolio company in the same industry. The industry connection can often give the buyer the flexibility to get quite creative with financing alternatives.

While the financing markets have become increasingly difficult, the use of some of these financing vehicles can allow transactions to continue to be closed. In further explaining Ancor's success in closing two transactions in such a difficult market Mike Evans, Managing Director, said, "our operational expertise in health care and in food processing gave us credibility with lenders and the efficient use of mezzanine capital allowed us to close these two transactions in the challenging market."

The effective use of some of these financing techniques can allow deals to get done even in the tumultuous times we are experiencing in today's market.

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