Finding Sources of Funds for Financing Acquisitions

By Thomas J. Williams

NEW DIRECTION PARTNERS

One company acquiring another company is a straightforward proposition, but for the buyer, securing the funds needed to make the transaction happen can be more complicated. Here's an overview of where to look and what to keep in mind.

Acquiring a printing or a packaging company is a complex process – and so is arranging the funding that makes the transaction possible. Most buyers, and especially those making their first acquisitions, will have homework to do about putting together the "stack" of capital they'll need.

The general approach depends on whether the buyer is acquiring for strategic or financial reasons. Strategic buyers typically are owners of printing and packaging companies who want to acquire other printing and packaging companies in order to grow their existing businesses. Financial buyers are investors seeking high returns on the money they put up, but not necessarily permanent ownership of the assets they acquire.

Another distinction between them is that while financial buyers have access to their own pools of funds, strategic buyers usually have go out and find the resources that their deals call for. In this article, we'll concentrate on identifying methods of financing for strategic buyers, which can include assuming seller debt as well as drawing upon various sources of cash.

Often, a strategic buyer will partially fund an acquisition through bank debt: for instance, a revolving line of credit secured by inventory and accounts receivable. These funds, allocated for working capital, can be supplemented by a term loan secured by equipment of the business that is being purchased.

Into the 'Mezzanine'

The next level of borrowing could come from "mezzanine financing" by non-bank entities such as insurance companies, private equity (PE) firms, and personal finance lenders. The bank financing gets a first lien on assets in the event of a loan default. The mezzanine lender's second lien increases both the risk and therefore the rate of interest that the mezzanine lender is able to charge.

The collateral value of the pledged assets sets a limit on what the bank usually will lend. Mezzanine financing, on the other hand, can be wide open in terms of loan amounts, based on how the lender views the historical performance of the company to be acquired and the business plan for the combined companies going forward.

The search for funding doesn't have to end with bank and mezzanine financing.

Another source could be seller financing, where the seller becomes the lender by taking back a promissory note for a portion of the purchase price. In some acquisitions, friends and family members join the buyer as co-investors. We've also seen instances where strategic buyers accept PE firms, individual investors, and "family offices" representing wealthy individuals as minority or majority shareholders in transactions. Or, a buyer will simply leverage personal assets – for example, a home, other real estate, and stock portfolios – to borrow needed money from a traditional lender.

Still another way to finance an acquisition is to assume the seller's debt as a share of the purchase price – basically, by subtracting the amount of the debt from the price the buyer agrees to pay. A caveat is that the original lenders of the debt to be assumed must be notified before the deal can close. The reason is that loan documents almost always have language specifying that a change of control represents a default under the terms of the loan agreement. To avoid triggering one, the lenders have to know and approve of what the buyer intends to do.

'Debt-Free, Cash-Free'

More commonly, transactions known as "debt-free, cash-free deals" take debt out of the picture by requiring the seller to use cash at closing and other resources to pay off existing obligations. That way, the acquired company goes to the buyer without any financial complications hanging over it.

Bear in mind that there is no set formula for financing an acquisition. Every deal is different, and every buyer uses his or own mix of the options described here.

It wouldn't be unusual for the mix to consist of a certain amount cash at closing; a seller note for a portion of the purchase price; bank and mezzanine lender financing for another portion of it; and an earn-out payment over time to the seller, based on future performance that meets specific financial goals in the business plan. But, a deal delivering full cash at closing to the seller would be extremely unusual – it's a type of transaction we rarely see.

The buyer establishes the terms of the acquisition during the negotiations leading up to the presentation of a letter of intent to the seller. The LOI spells out how the buyer intends to pay the seller even though, at this stage, the buyer may not necessarily have nailed down all the details of the financing. This takes place in the period of due diligence – typically about three months – between the seller's acceptance of the LOI and the formal closing of the deal.

Slowed, but Far from Stopped

It might be imagined that COVID-19 put a damper on the lending climate for buyers, but in our experience, this wasn't the case. What we did see were extended periods of due diligence, but not because funding had become harder to get. The explanation lies in the fact that due diligence usually obliges buyers to hire third parties to assist them: for example, accountants, environmental firms, and specialists in things like inventory and equipment appraisal. At the height of the pandemic, these people couldn't travel, and due diligence slowed down accordingly.

However, those interruptions are now mostly behind us, and the pace of business in mergers and acquisitions is returning to what it was. From the financing perspective, interest rates remain historically low; banks continue to be receptive to strategic buyer-borrowers representing well-managed printing and packaging firms; and PE investors still have abundant cash for what they see as smart plays within the industry.

It all augurs well for owners who are ready to grow by acquisition. By planning their financing as carefully as they pick their targets, they'll be properly positioned to make the right deals with the right sellers at the right time.

New Direction Partners is an investment banking and financial advisory services formed by Peter Schaefer, Paul Reilly, Jim Russell and Tom Williams to serve the printing and related industries. Services include merger advisory services through the representation of selling shareholders as well as buy side representation, valuation services, financing and refinancing efforts, turnaround and restructuring services, and temporary/interim management consulting. To learn more about New Direction Partners, visit New Direction Partners' website at www.newdirectionpartners.com.