Four Approaches to Cashless Acquisitions

In one way, buying a company can be like buying a car or a house: when it comes time to pay, there are more options than just paying with cash you have in the bank. Here are the four approaches most commonly used:

1. <u>Pay with Stock</u>

You can use stock in your company (which will become the combined company) to pay the purchase price.

For Sellers. If it's structured right, the transaction is tax-free to the sellers. As a result, sellers can get more value, since buyers can afford to pay more. It can be especially appealing if the buyer's stock is publicly traded, since the consideration is relatively liquid. However, if the buyer is a private company, some sellers are reluctant to accept illiquid stock.

For Buyers. For public company buyers, when markets are up we see more stock-for-stock mergers. Higher share prices result in fewer shares being issued, which means less dilution to existing shareholders. Especially in private companies, too much dilution can create a second set of negotiations, since existing shareholders may have to be convinced of the value of the deal.

2. <u>Debt Financing</u>

Most companies borrow money to pay at least some of the purchase price.

For Sellers. Sellers may be reluctant to enter into a transaction that has a financing contingency. It's like selling a house: would you rather sell to a person who has cash in the bank or a pre-approved mortgage, or to a person who has to go out and get a mortgage?

For Buyers. Buyers have to keep debt service in mind and understand how the acquisition financing fits within their whole capital structures. It is often better to have debt in place before seeking a target in order to simplify the transaction and make the offer more appealing (buyers who are trying to set up a credit facility and other debt at the same time as an acquisition risk having to pay for an expensive bridge loan, then refinance after the closing). Also, lenders may want to conduct their own due diligence on a target, and any surprises that come up may slow down the deal. Keep in mind that buyers who have visible resources and a history of being able to complete acquisitions have an easier time finding sellers who will accept a financing contingency.

A leveraged buyout is a variation of debt-financed acquisitions in which cash flow from the target is used to support debt service and in which the target and its assets become collateral for the loan.

3. Equity Financing

Companies can receive general or deal-specific equity financing at the time of a deal.

For Sellers: The main concern of sellers with buyers who are seeking equity or other financing at the time of a deal is whether that financing will materialize.

For Buyers: It can be easier to get financing if the investors know how their funds are being used. While an investor would probably want to do some of its own due diligence on the target and buyer's ability to integrate the target, it can be appealing to know that funds invested will be spent on an acquisition rather than sitting in a bank waiting for an opportunity. However, buyers still have the same concern as sellers about trying to close a financing at the same time as an acquisition. In addition, some buyers are concerned about the side effects of investor financing, like transaction costs and dilution of owner's equity. However, new investors can bring contacts, industry knowledge and experience to the combined companies.

4. Seller Financing

Seller financing is different than an earn-out or other contingent payment. In a seller financing, the seller takes back a note for part of the purchase price and the buyer commits to pay over time without contingencies.

For Sellers: Sellers have a number of concerns about becoming a financing source. Does it make sense to rely on buyer's credit? Do your owners want to get paid out right away rather than over time? Does the interest rate on the note make it a worthwhile investment? Does the total purchase price make seller financing worth considering? If Buyer later has qualms about the transaction, what is the chance it will try to offset payments on the note against whatever claims it may have? What kind of subordination and intercreditor agreement will Buyer's other creditors insist on? Will there be collateral as security?

For Buyers: Buyers often like seller financing, since it is deal-specific and does not draw on the buyers' other resources. It is a way to bridge a gap between what existing investors and operating funds can provide and what a seller needs in order to agree to a deal. However, it is not nearly as appealing to a potential seller as cash in the bank. It adds an extra layer of complexity to buyer's capital structure, may require an extra layer of compliance and may require approval of buyer's other creditors.

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At the end of the day, debt financing from third parties or a seller will require cash out of pocket as debt service, while equity investments by their parties or a seller (which is essentially what a stock-for-stock merger is) will not. The transaction costs and level of complexity the options add to the process will vary, too. It is important to model the various alternatives and consider the input of all the stakeholders in deciding which path to follow.