MERGER & ACQUISITION FOCUS

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Ask the Advisor

Line up your financing early

If you're in the market to buy a business, consider arranging your financing strategy well before you've identified a target and drafted your letter of intent. Early preparation could help you refine your search by showing how much you're able to borrow on your own cash flow and assets, and the approximate financial health required in a target acquisition. It also may strengthen your position as a credible buyer with sellers and eliminate the embarrassing possibility of needing to cancel your bid because of a financing problem.

Financing sources

For a prospective buyer, the four main sources of financing are: 1) banks, 2) private equity firms, 3) an initial public offering (IPO), and 4) seller financing. If you want to retain full control of your business, you probably want to rule out a private equity firm or IPO. While private equity and IPOs offer certain advantages, they require you to transfer equity to outsiders.

Seller financing offers advantages, especially if you can't find financing elsewhere. But if you have other options and don't want to depend on seller credit, which might not be available, bank financing is a convenient, cost-effective alternative.

The seller won't have much incentive to let you proceed with due diligence if your financing ability is in question.

Your existing bank is the best place to start financing discussions. However, if your bank doesn't understand your business or industry, or doesn't do much acquisition financing, consider finding another one that's better suited to your long-term needs. Many banks specialize by industry, so investigate your options and take the time to find a lender that understands your company.

Bank loans

Once you've found a bank that's interested in working with you, it will look at two aspects of your business and the acquired business:

1. Unsecured assets. These are assets that aren't already held as collateral for an existing loan and will serve as collateral for the new loan or loans you seek.

2. Cash flow. The most common measure of cash flow is earnings before interest, taxes, depreciation, and amortization (EBITDA). Cash flow is relevant because it will be the source of funds to cover periodic interest and principal payments on any loans.

Bankers don't make loans unless they're comfortable with their recourse (collateral)

in the event of default and the borrower's ability to meet borrowing costs. In the case of loans to small and midsize businesses, banks often ask for personal guarantees from owners as well.

Multiple loans

Your business's assets may be able to support multiple bank loans. To determine how much to lend, the bank will look at asset classes separately, because each class has its own lending criteria. The bank's policy might be to lend no more than 50% of the value of your inventory. It may, however, be willing to lend up to 80% of the market value of equipment.

The interest rate will depend partly on the ratio of the borrower's EBITDA to its senior funded debt, also known as the debt service "coverage ratio." The higher the ratio, the lower the risk to the bank, and, therefore, the lower the borrower's interest rate. The interest rate for small to midsize companies is typically one to two percentage points over the prime lending rate.

Convincing the seller

Once you've identified a lender and an acquisition target, and performed your initial analysis of the potential deal, you'll sign a letter of intent with the seller. The letter will state an asking price, and describe your financing strategy and other material deal terms. Even if the funds you've borrowed don't cover the entire asking price, the letter will make a stronger case to the seller that you're serious.

Indeed, the seller won't have much incentive to let you proceed with due diligence if your financing ability is in question. And having lined up financing could be important if you're competing with other prospective buyers. In the event of partial financing, the seller — and your bank — will understand that any remainder of the purchase price will be financed based on the assets and cash flow of the acquired business.

Finally, if you line up financing beforehand, you reduce the remote possibility that your bank will significantly delay financing approval — or even deny the loan at the last minute because of a perceived problem with your financial position. If your bank has an issue with your assets or cash flow, it's better to know about it sooner rather than later.

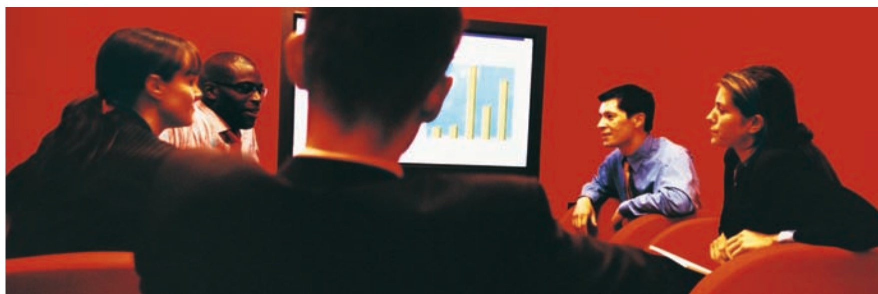
Key step

The advantages gained by positioning yourself with the seller as a well-qualified buyer could make the deal a reality. Ultimately, this can move the process along by accomplishing a key step early in the game.

Measures that matter

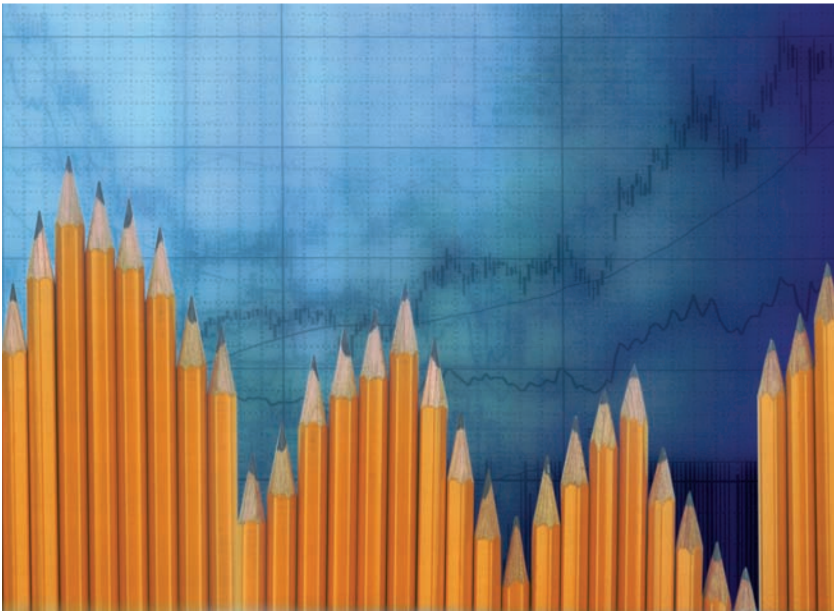
How M&A professionals track the industry

Mergers and acquisitions have become a major feature of the global financial marketplace. Deal participants include public and private companies of all sizes, investment banks, business brokers, commercial banks, private equity funds, institutional investors, hedge funds, and legal and accounting firms. To track this active and diverse sector, M&A professionals watch a variety of key trends and measures to help evaluate prices, financing and risk.



The economy

The current health and direction of the economy is of tremendous importance to mergers and acquisitions. Simply put, M&A activity requires a healthy economy to thrive. Experts, therefore, keep an eye on economic indicators such as gross domestic product, job growth, unemployment rates and others. Consumer and business spending — the main drivers of economic growth — also are important to track, as are housing starts and home sales.



Private equity firms raise money from investors and, combined with borrowed money, use the proceeds to buy businesses for their investment portfolios. After a holding period (generally three to five years after being acquired), the businesses exit private equity portfolios by going public, being acquired by a corporation, or being sold to another private equity fund or intermediary.

M&A professionals pay close attention to this holding and selling cycle. The primary measures of deal activity are the total number of transactions (or businesses purchased), total dollar volume and average dollar amount. Transaction activity can be refined for analysis by market segment.

The rate of inflation and the Federal Reserve's discount rate — the interest the Fed charges banks for borrowing short-term funds — affect both the overall economy and the financial markets because they in turn set commercial interest rates. When interest rates are low, buyers can afford the credit they need to make acquisitions, whereas high interest rates curtail deal activity by making it too expensive to be profitable.

The corporate sector

Corporations act as both buyer and seller, so their financial health merits special attention. M&A experts look at market data on the growth or decline of corporate profits, debt-to-equity ratios, price-earnings ratios, price-cash-flow ratios and ratios of balance sheet cash to business market value for a range of business segments. These rates and ratios signal the profitability of businesses, how expensive they would be to buy, and how much cash they have available to buy other companies.

Metrics such as these are available for public companies and those private companies that have chosen to participate in financial reporting surveys. Databases such as Standard & Poor's, Thomson Financial and FactSet Mergerstat are sorted for company size, industry, financial strength and other attributes of interest to prospective buyers and sellers.

The transaction cycle

Shaped by general economic and corporate activity, M&As often occur in a circular pattern of purchases and sales facilitated by private equity firms and other intermediaries, such as hedge funds, insurance companies and pension funds.

For example, you can get transaction data for the middle market — broadly defined as companies with sales between $10 million and $500 million. The data can be refined further for narrower ranges such as revenues of $10 million to $100 million.

Valuation and debt

Valuations, or the prices for which companies sell, are perhaps the most closely watched metric in the M&A arena. A business's value often is expressed as a multiple — the ratio of a company's selling price to the cash flow it generates, commonly defined as earnings before interest, taxes, depreciation and amortization (EBITDA). Alternate valuation metrics may include a multiple of enterprise value (the selling price of the business plus amount of net debt on its balance sheet) to EBITDA, or a multiple of revenues.

Given the extensive use of debt in M&A transactions, leverage and credit-quality metrics generally receive as much attention as valuation ratios. Two ways of tracking leverage — the amount of debt that acquirers take on to finance their purchases — are the total dollar volume of M&A-related borrowings and the multiple of total debt to EBITDA in new deals.

Integrating complex information

As a seller or buyer, you may not have the economic and financial background to understand the complexities of the M&A marketplace. But having some basic knowledge of how your advisors view broad trends can help you establish a better working relationship with them and smooth the transaction process.

Valuing C corporation assets

A potentially contentious situation

The sale of a C corporation can be structured as a stock or asset sale. Either method has its advantages and disadvantages, and they may differ for both buyer and seller.

If you choose an asset deal, valuing business assets can be a challenge. The IRS requires that the total sales price be allocated among the assets sold, with income and capital gains taxes due according to the category and tax basis of each asset. But because the tax consequences of allocations can be different for buyers and sellers, valuing assets can become a contentious process.

> *Unlike sellers, buyers aren't concerned about the assets' former tax basis.*

Opposite viewpoints

When a C corporation is sold, the seller and buyer must agree on allocations of the sales price to assets and then report them to the IRS. The allocations also should be included in the sales contract as a matter of record in the event of an IRS inquiry.

Buyers and sellers may seek different values to be allocated to the same asset. If the allocated price for an asset is higher than its tax basis, the buying entity typically "steps up," or increases, the asset's basis to the higher value. The step-up doesn't have an immediate consequence for the buyer, but over time the step-up can boost the asset's cash flow significantly by increasing its annual depreciation or amortization for tax purposes. This M&A benefit often is referred to as a "tax shield."

The allocation process can have a much different tax effect on the seller of the C corporation because, depending on how the IRS categorizes an asset, the profit on the sale of any asset is considered ordinary income or capital gain. Rather than generating the long-term tax advantages gained by the buyer, price allocations can subject the seller to corporate taxes for the current tax year.

To reduce taxes related to the sale of an asset, the seller may want a low value assigned to it. The buyer, on the other hand, may want the same asset to be stepped up to a higher value to maximize future depreciation for tax purposes.

How the IRS allocates

For its part, the IRS requires that the allocated price for an asset represent fair market value (FMV), or the price at which an asset would sell on an open market between a

Asset vs. stock deals

Sellers of C corporations typically prefer stock deals, which don't incur corporate taxes. Taxes are only due to shareholders whose stock price exceeds its tax basis. If the sale of the C corporation is structured as an asset deal, however, shareholders may be taxed twice: first when the company pays corporate taxes on the profits of the asset sale, and second when the shareholders pay taxes on a dividend or liquidating distribution made by the business.

C corporation buyers, on the other hand, usually prefer asset deals, which allow buyers to purchase only the assets they want and to step up the assets' tax bases. They also allow buyers to avoid assuming the seller's known — and unknown — liabilities.

willing buyer and seller. This broad definition allows some price flexibility for buyers and sellers.

To determine the appropriate tax treatment, the IRS divides assets into six classes, two of which are for intangible assets such as goodwill, with the remainder for cash, inventory, plant, equipment and other tangible assets. Classifying an asset helps define whether the profit from its sale will be characterized as ordinary income or capital gain for the seller. If an asset's allocated value is less than its tax basis, the seller can recognize the difference as a taxable ordinary loss or capital loss.

Seller, buyer strategies

Sellers wishing to reduce tax exposure should avoid allocating high values to assets that will incur ordinary income tax treatment and to capital assets with low cost bases. Heavily depreciated fixed assets that are allocated high values are of special concern to sellers because of depreciation recapture — ordinary income tax treatment for all past depreciation, plus capital gains treatment for any gain over the assets' original book value.

Another tax-reducing strategy is to move ownership of corporate real estate into a limited partnership well in advance of selling the company, and then lease it to the buyer following the sale. This helps the seller avoid heavy capital gains taxes on real estate that has appreciated significantly over a long period.

Unlike sellers, buyers aren't concerned about the assets' former tax basis. Instead, they try to assign the highest possible price to assets, such as business equipment, that can be depreciated or amortized rapidly. Assigning a high value to inventory is another cost-effective tactic because it quickly reduces taxable income by increasing the cost of sales. Note, however, that allocating a high value to real estate isn't always advisable, because land isn't depreciable for tax purposes.

Useful advice for both

Although buyers and sellers have different pricing strategies, some advice is useful for both parties. First, each should have an experienced tax advisor to help with the negotiating process. Next, all prospective decisions should be viewed in terms of their after-tax effects. For example, the total selling price of a business's assets ultimately matters less than the total after-tax pricing of individual assets.

Finally, both buyer and seller need to recognize that a taxable transaction, such as an asset deal, often occurs at a premium to a tax-free or partially taxable sale. Sellers need compensation for the immediate taxes they have to pay, and buyers are more likely to pay up for the tax shield they gain from stepped-up tax bases.

Compromise and consensus

Tax consequences play an important role in asset deals, so agreeing on a total selling price for assets represents an intermediate step in the negotiation process — not the final one. Both you and the other party should understand that price allocation decisions can have contrary tax consequences. But if both parties are committed to open communication and compromise, you'll be well on your way to completing a successful transaction.

Q. Is there still a distinction between strategic and financial acquirers?

A. For many years, M&A experts have distinguished between strategic and financial buyers of companies. Strategic buyers look for businesses that can complement their existing companies, seeking synergies by merging operations. Financial buyers typically intend to run an acquired business independently for the purpose of improving its internal operations, and then selling it at a profit.

Deal history

The distinction between these two types of buyers dates back to the emergence of the buyout business in the 1970s and 1980s. During this period, firms such as Kohlberg Kravis Roberts & Co. and Hicks, Muse, Tate & Furst, and takeover tycoons such as T. Boone Pickens, Ronald Perelman and Carl Icahn, launched widely publicized bids to acquire businesses or large stakes in them, later selling them profitably.

These individuals and firms were considered financial buyers because their focus was clearly transaction-oriented. While they may have made operational changes in the acquired firms by cutting costs, offering equity incentives to managers and restructuring balance sheets, the buyers generally didn't merge them with other companies to benefit from synergies.

During the same period, strategic acquirers were intent on integrating acquisitions with existing operations. The synergies could be horizontal — adding businesses in the same industry to achieve scale or greater geographic reach — or vertical, allowing the acquirer to extend its control over suppliers or distributors. Many of today's oil companies, for example, grew by making acquisitions that expanded their control of petroleum drilling, refining and marketing.

Current distinctions

Although strategic and financial acquirers still exist, they increasingly cross lines. Today's private equity firms don't just focus on operational and financial restructurings of the businesses they acquire. They also make strategic acquisitions — vertical and horizontal — to merge the target with other companies in their investment portfolios. And corporate acquirers sometimes make nonstrategic acquisitions to take advantage of low prices or diversify from their core business.

Berkshire Hathaway, which has achieved resounding success principally by making financial acquisitions, is one good example. Today, some corporations make strategic acquisitions, some make financial ones, and some make both.

Lesson for sellers

The shift in the formerly well-defined roles of M&A acquirers offers an important lesson for sellers. The traditional rule that strategic acquirers pay more than financial buyers often is still the case, but you shouldn't assume a prospective buyer is one or the other without investigating thoroughly. A corporate buyer might be interested in your business if it can get it at a low enough price, and a private equity firm might already own a company that would integrate well with yours.

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