Merger & Acquisition Focus

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Solve your credit crisis with seller financing

With much of the credit markets in a deep freeze, M&A activity has, not surprisingly, declined. Many buyers simply can't find the financing they need to make acquisitions. A prospective seller, however, can attract buyers or help keep a planned deal alive by agreeing to finance at least part of the acquisition by deferring a portion of the selling price.

Popular strategy

Some business owners may be reluctant to go this route, but seller financing offers attractive incentives. First and foremost, it helps ensure that the transaction gets completed — no small feat in the current economic environment. What's more, it can be structured to provide sellers with rewards for putting their own capital on the line.

Seller financing is, in fact, fairly common, and generally plays some part in most M&A transactions. It can make up as much as 40% of a deal's purchase price, though as of December 2008 seller financing more typically has made up 6% to 7% of the purchase price, according to the financial consulting firm Succession Planning Consultants.

Creative problem solvers

Although seller financing is flexible and can be used in a variety of ways, a couple of basic structures are followed in the majority of M&A deals:

Installment plans. Installment plans are popular because they don't require sellers to contribute any capital. Sellers agree to accept a "down payment" from the buyer when the deal is signed, and receive the remainder of the purchase price in installments over a period of time — usually five to seven years.

Loans. Another popular form of seller financing involves a loan made by the seller to the buyer. If, for example, a buyer wants to make a $10 million acquisition, but has only enough cash to finance $8 million of the purchase price, the seller could agree to make a $2 million loan to get the deal done.

Typically, a seller making a loan is protected by a "confessed judgment" promissory note backed by a security agreement. If the buyer defaults on the note, the seller can obtain a court judgment without formal litigation. The security agreement lists the loan's collateral — generally the buyer's business, and in some cases other assets.

Benefits both parties

Both types of financing provide buyers and sellers with advantages. Buyers, of course, are able to make an acquisition they might not otherwise have been able to accomplish. And if they finance the deal with an installment plan, they keep additional debt off their balance sheets, potentially strengthening their overall financial profile. Both installment plans and seller loans enable buyers to avoid banks and other traditional financing sources, which are likely to have much stricter lending criteria, terms and covenants.

Seller financing can be an ideal solution for sellers who don't want to wait for the economy to improve because, for example, they're ready to retire. And as a reward for participating in an installment plan or seller loan sale, they typically receive a higher-than-market-average interest rate on subsequent payments. Sellers may also enjoy tax advantages. Rather than receiving the entire purchase price when the transaction closes and incurring an immediate tax obligation, sellers can defer a portion of the taxable gain over a period of years.

Seller financing won't work for every deal, though. If a seller needs the full amount immediately to sink into a new business, for example, installment payments probably aren't an option. And although seller financing typically has strong protections in place, it relies on the management skills and continued financial health of the buyer. If the buyer fails and declares bankruptcy, the seller will be competing with other creditors to recover its money.

Cooperation is key

Given the volatile nature of the current credit markets, M&A deals must be cooperative efforts if they're to succeed. Both parties should work together to find creative financing solutions that enable them to, if necessary, circumnavigate a frozen lending pool. If sellers can afford to pitch in, seller financing may be the fastest and easiest way to close a deal to everyone's satisfaction. ■

The paper option

Loans and installment plans are only two ways business sellers can help buyers make an acquisition. Seller financing options also include several "paper" options, including:

Traditional seller notes. These are covenant-free notes that fall below mezzanine debt in a company's capital structure, and generally feature set short-term maturities and interest rates (typically in the 8% range).

Senior seller notes. These debt obligations are ranked higher than traditional notes in the buyer's capital structure. Sellers, therefore, can get repaid faster, but faster repayment usually comes at the price of a lower interest rate. Additionally, lenders often require all other debt to be subordinate to their notes, so be prepared to defer priority to institutional lenders.

Subordinated financing. These are notes that serve as an alternative form of "bridge" financing. Subordinated debt often is considered the financing of last resort for buyers and typically includes many seller protections — including restrictive covenants.

A recent deal illustrates how the paper option might work. Last year Sopra Capital acquired home-inspection company HouseMaster, and the transaction was financed with two-thirds equity and one-third senior seller note. Sopra turned down a senior bank financing plan for a five-year, 8% seller note.

Selling a distressed company at a healthy price

As the financial markets' malaise ripples through the business world, more and more companies are becoming "distressed." In other words, they're unable to meet their financial obligations, including routine expenditures and debt payments. If your company is in this position, selling it may be your best option.

Distressed companies face obstacles healthier companies don't — namely, finding a buyer that will accept the financial challenges and pay you a fair price for the opportunity to turn your business around. You don't necessarily have to settle for a fire-sale price but you do need to understand what you have and how you can market it most effectively.

Start with the "worst case"

Begin the sale-preparation process by evaluating your company on a worst-case — or liquidation — basis. This means you need to value your assets at current levels, most likely below going market rates. If you have real estate holdings, for example, run a conservative analysis that accounts for the currently depressed property and credit markets.

If you own exclusive rights to valuable processes or products, list them prominently in your offering prospectus.

Valuing assets on a liquidation basis gives you a "rock bottom" price for your business. If buyers approach you with a lower bid, you'll know they're undervaluing your company and looking for a "steal." And knowing how low you should go gives you a strategic advantage during negotiations.

Know what to sell

Making a sales proposal for a distressed company may sound difficult — and, in fact, it is. But your company can still prepare a compelling proposal if you understand its strengths and the qualities buyers are likely to seek in an acquisition target. These include:

Personnel. Many prospective buyers are attracted by skilled and experienced employees. These include personnel who have:

- Developed strong client or customer relationships,
- Helped establish well-known brands,
- Developed successful products or valuable intellectual property, or
- Posted high productivity rates.

Your company's productivity may have declined in the past year as the economy has soured. Be sure to clarify to prospective buyers when short-term productivity losses are due to overall economic or companywide factors, and not individual employees.

Future sales. When current sales are weak, point buyers to future sales opportunities. If your buyer offers complementary products, it might be able to sell yours to its existing customer base with little extra effort and cash outlays.

Proprietary information and services. If you own exclusive rights to valuable processes or products, be sure to list them prominently in your offering prospectus. Some buyers may be willing to acquire your company, including assets they don't need, simply to gain access to certain pieces of intellectual property.

Location. Sometimes, buyers are attracted to companies simply because their offices or production facilities are located in a preferred city or region. Buyers hoping to expand into your geographic territory may consider an already-established office and workforce highly desirable.

Keep everyone current

Once you've made the decision to sell, inform your company's lenders and investors and regularly update them on the sale status — particularly as you approach the negotiation stage. These outside stakeholders will be concerned about whether you're selling cheaply — or, conversely, holding out for too much. Lenders, for example, typically welcome any potential bid that doesn't grossly undervalue your company.

Also be honest with prospective buyers. If conditions continue to deteriorate, and your sales or revenues decline faster than anticipated or as stated in your offering materials, provide updated information. If a buyer gets the sense that you're hiding something, it may get cold feet. And companies that make deliberate misrepresentations can face financial and legal consequences.

Don't settle

Selling a distressed company — particularly if you've built it yourself — can be a painful process. But with the help of a team of experienced advisors, you can keep your focus on the remaining value of your operations and not worry about getting "taken" by opportunistic buyers. In fact, if you know the liquidation value of your assets and understand the current M&A market, you could make a deal you would have been proud to close even in more-prosperous economic times. ■

In shape to sell

HOW FIT IS YOUR BUSINESS?

Even if you're not ready to sell your business now, you should use the intervening years to make it more attractive to eventual buyers. To improve your company's value and fitness for sale, you'll likely need to firm up your balance sheet as well as subject operations and even employees to performance and productivity measures. Bolstering its overall health may also help it better weather rough environments.

Financial weak spots

Most companies — even very profitable ones running tight operational ships — need to prepare for the market if they want to get the best possible price. (If, on the other hand, your company is financially troubled, see "Selling a distressed company at a healthy price" on page 4.) Start by having your financial statements audited specifically for the purpose of improving your

company's value for sale. Because audits can, among other things, root out earnings mistakes and identify potential tax exposures, many business buyers ask sellers for at least two years of audited statements.

In the meantime, an audit will help your company identify financial issues — such as a high debt-to-equity ratio or a volatile earnings history — that need to be addressed and possibly remedied before you contemplate a sale. This process can take several years, so it's important to conduct an audit and tackle any issues as soon as possible.

Flabby operations

Another way to improve your company's overall value is to reduce inefficiencies and redundancies, thus reducing overhead. Consider making infrastructure improvements — anything from buying more powerful accounting software to upgrading production machinery to divesting underperforming assets. And consider whether eliminating redundant employees makes sense now, rather than when your company is purchased. Having fewer employees can improve your balance sheet and spare the eventual buyer the unwelcome task of conducting layoffs.

Other major areas that typically affect value and merit attention include:

Intellectual property (IP). Consider engaging an expert to research and determine which of your company's brands, copyrights, trademarks and other IP assets enjoy the highest market value. Armed with this information, ensure you (not, for example, former employees or contract workers) have legal ownership of the valuable assets and devote greater resources to promoting and protecting them.

Customer relationships. Analyze your company's current customer or client base and determine which relationships are the most profitable and which have potential for future growth, if, for example, you were to roll out a new product. Then focus on preserving and prioritizing those relationships.

Key employees and units. Break down your company's operations so you can identify which employees are the most productive, and which units are the most profitable. If certain employees or units correspond to highly profitable contracts, they're doubly valuable. Ensure that you retain your best employees by offering incentives, such as bonuses that will be paid after the company is sold.

Assessing risk

While you're trimming and strengthening operations, think about the types of buyers that are likely to emerge from the current credit crisis, seeking acquisition targets. This may vary by industry, but most buyers probably will be more risk-averse than they were in the past, and they may be wary of acquiring highly leveraged businesses.

Break down your company's operations so you can identify which employees are the most productive.

Determine the risk your company might represent to a buyer by having a risk assessment performed. Experts will undertake a sort of mock due-diligence process to uncover items that often wave red flags to potential buyers. This kind of analysis, for example, could reveal that a business relies too heavily on one particular customer or client, has failed to properly establish legal ownership of a valuable piece of IP or has inadequate internal controls, making it more vulnerable to employee fraud schemes.

You have time, but not forever

Don't rush through the process of boosting your company's value. Depending on the weaknesses you uncover, it could take awhile to get it into shape. But don't drag your feet on selling or fixate on resolving every last issue, either. Instead, think of it like training to run a marathon: You'll never be absolutely ready, but at some point you'll be ready enough to run the race and successfully cross the finish line. ■

Ask the Advisor

Q. Should my distressed company consider a debt restructuring?

A: If your financially distressed or troubled company faces severe cashflow problems, you may need to seek alternative methods to satisfy your outstanding debts. In most cases, businesses like yours have few options. You might file for bankruptcy protection or — in a best-case scenario — sell to a buyer seeking a turnaround opportunity.

Such acquisitions, however, can prove difficult and may even collapse because most buyers aren't eager to deal with a target's angry creditors or pay their delinquent loans. But an out-of-court debt restructuring, or workout, could protect your distressed company and make it a more attractive acquisition.

Less extreme alternative

Out-of-court debt restructuring is a process by which a public or private company informally renegotiates outstanding debt obligations with its creditors. The resulting agreement is legally binding, and can enable the distressed company to reduce its debt, extend maturities, alter payment terms or consolidate loans.

Debt restructuring is a far less extreme and burdensome (not to mention less expensive) alternative to filing for Chapter 11 bankruptcy protection. Academic studies have found that average legal fees reported by Chapter 11 companies range from approximately 3% to 8% of total assets. But a study conducted by Professor Theodore Barnhill, which sampled debt restructurings, found related costs to average only 0.65% of the book value of assets. Choosing debt restructuring further enables potential M&A deals to continue moving forward.

As time is generally of the essence for distressed companies, the process can provide a streamlined means for dealing with debt. Typically, companies don't have to negotiate with each one of its creditors; reorganization can be adopted with majority consent. And larger investors and bank lenders often are more receptive to a reorganization than they are with taking their chances in bankruptcy court.

Degrees of debt

There are two basic types of out-of-court debt restructuring:

General. This type of negotiation buys the distressed company the time needed to regain its financial footing by extending loan maturities, lowering interest rates and consolidating debt. Creditors typically prefer a general restructuring because it means they'll receive the full amount owed, even if it's over a longer time period.

General restructuring suits companies facing a temporary crisis — such as the sudden loss of a large customer or supplier or departure of key management team members — but whose overall financials are still strong. Debt structure changes can be permanent or temporary. If they're permanent, creditors are likely to push for higher equity stakes or increased loan payments as compensation.

Troubled. A troubled debt restructuring, on the other hand, requires creditors to write off a portion of the distressed company's outstanding debt and permanently accept those losses. Typically, the creditor and debtor reach a settlement in lieu of bankruptcy.

This solution is appropriate when a company simply can't pay its current debts at current interest rates and the only alternative is bankruptcy. Creditors may receive some compensation, however, with increased equity shares in the business or, if it's acquired, in the merged company.

Bring everyone to the table

If your company is facing a financial crisis that could destroy it or hinder its acquisition, you might want to consider an out-of-court debt restructuring. But don't try to do it alone. This complicated situation requires the input of experienced financial and legal professionals who can help you draft a plan of action and bring all the parties — owners, potential buyers, investors and lenders — to the negotiation table. ■