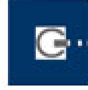

Grandview National

INVESTMENT BANKERS

www.GNIB.com

How to Finance a Business Purchase

By Mark Pittman

Thinking about purchasing a business? Specifically, if you're trying to sort out what's involved in the acquisition of a small and/or middle market business, there are a number of factors to consider, including:

--Different types of financing.
--Sources of financing.
--How to choose which type of financing is suitable for a specific transaction.

Types of Financing

Seller Financing

Seller financing typically occurs when the buyer is either unable or unwilling to finance 100 percent of the purchase price, or when the seller wants to share in the upside of the business. Seller financing generally entails either the seller receiving a note from the buyer, or the seller receiving earn-out payments. Seller financing is frequently found in small business deals, as it is more difficult for small businesses to qualify for other types of financing. Our firm has found that in transactions between $1million and $5 million, approximately 80%-90% of the deals involve some type of seller financing.

When a buyer provides the seller with a note, the interest rate and term must be negotiated. On small business deals, rates tend to range from 2 to 5 percent above prime, and the term falls between one and five years. Personal or parent company guarantees on the note must also be negotiated. Another key issue is collateralization. For example, the note may be secured by the buyer's stock, the assets of the business, or other assets, such as cash held in a bank. Methods to secure a note are only limited by the dealmaker's creativity. For example, on an international transaction our firm once arranged to have a client's multi-million dollar note secured by a certificate of deposit in an off-shore bank. In order to satisfy our client's legitimate concerns, we engaged the former head of the DEA in the region to perform due diligence on the bank.
An earn-out occurs when the buyer agrees to pay the seller an additional pre-defined consideration as certain milestones are met. Common milestones include revenue or earnings targets, and client/customer retention goals. Buyers favor earn-outs because they provide incentives to the seller to make sure the business transition is successful. Sellers prefer earn-outs when they believe the business has growth

potential and they want to share in the upside. However, earn-outs can be risky for sellers as the buyer may mismanage the business, thus reducing the value of the earn-out.
In addition, buyers prefer seller financing because buyers may offset their deferred payment obligation against a seller's indemnity obligation arising from a seller's breach of a purchase agreement representation and warranty or covenant. Be effecting the offset, a buyer recoups its losses for which the buyer claims it is entitled to indemnity without having to pursue the seller.

Equity Financing

Equity financing occurs when the buyer, whose stock is publicly traded, either exchanges its stock for that of the seller's, or sells its stock to raise acquisition financing.

The first scenario has the potential benefit of qualifying as a "tax-free" exchange. (This is actually misnomer, as the taxes are merely deferred until the seller sells the stock.) For a buyer, this method of payment conserves cash. On the other hand, it also dilutes the buyer's existing shareholders. Sellers considering whether or not to accept the buyer's stock must closely examine the type of stock (i.e. common or preferred) being offered as well as any restrictions on the stock, such as holdbacks that may be required. Further, the seller must carefully consider the value of the stock by examining its historical performance, the company's current valuation (i.e. whether the company's price/earnings ratio is materially above or below industry averages, etc.), and the float on the stock.

For example, in 2005 our firm received a $12 million offer for a client's business, of which $4M of the consideration was payable in the seller's stock. While the stock was unrestricted, we felt that the stock that had a price-earnings ratio of 40 (while the industry average was closer to 20) was substantially overvalued.

The client passed on the deal. Six months later, the seller's stock collapsed to less that half of its original value, which would have cost the more than $2 million.
In some cases, such as when the assets of a business are being purchased or the seller does not want the risk associated with the buyer's stock, it's more sensible to have the buyer sell publicly traded stock to third parties to raise financing for the purchase. Stock can be sold in a number of ways, including secondary public offerings and PIPEs (private investment in public entities).

Debt Financing

Debt financing can cover small business purchases or middle-market M&A transactions. For purchases of small businesses, the most common types of debt financing are:

-SBA loans.
-Loans provided by commercial lenders that are subordinated to the SBA loan.
-Franchise loans provided by franchisers to franchisees.
-Loans secured by business assets such as inventory and receivables.

For the acquisition of middle-market companies, debt financing is generally provided in the form of (i) senior debt or (ii) subordinated debt. Senior debt represents loans given to a company that are in a first priority position, both in terms of payment and collateral, in that they are not subordinated to any other type of debt.

This type of debt is available for a variety of uses, including the acquisition of businesses. Subordinated debt is generally considered to be all other types of debt that are subordinated to senior debt, and may even be unsecured. Subordinated debt includes mezzanine financing (typically longer term debt with higher rates that can include conversion rights) and bridge financing (a short-term loan to a buyer that is repaid once longer term financing is secured).

According to Joel Berman, a partner in the Century City office of the law firm of Jeffer Mangels Butler & Marmaro LLP, commercial lenders are typically looking for companies with strong balance sheets and solid management. Berman - who specializes in mergers and acquisitions, corporate finance and business law - has observed that the market has become extremely competitive for commercial lenders. "As a result," says Berman, "fees and rates on commercial financing deals have been falling, and commercial lenders are willing to work on smaller deals, especially in the $5 million to $10 million range." Despite the competitive loan pricing pressures, Berman notes that commercial lenders invariably demand that the principals of the borrowers sign personal guarantees.

Sources of Financing

Sources for financing the purchase of a business include:

--SBA lenders
--Lenders that provide subordinated loans in conjunction with SBA loans
--Franchisers that provide financing to franchisees
--Equity sponsors
--Private equity groups
--High net worth individuals
--Institutional investors
--Mutual funds
--Merchant banks
--Commercial banks.

Choosing the Right Financing

When deciding what type of financing is most applicable to a transaction, a purchaser must consider a number of factors:

Profile of Target Company
A target company with inventory or receivables is more likely to qualify for asset-based lending from a commercial lender or bank. Also, a company that has generated consistent cash flow is more likely to find favor with lenders.

Timing
A purchaser must consider the timing of the transaction, as some types of financing take longer to complete than others.

Amount of Financing Required
A purchaser must weigh the amount of financing required, as this may limit certain sources.

Profile of Purchaser
Finally, purchasers must consider their own financing capabilities. For example, a public company will have the ability to exchange its stock for a seller's stock, or sell additional stock to finance the acquisition. Also, a buyer with a strong financial history will be more likely to raise senior or subordinated debt based upon financial statements.
For a business buyer seeking acquisition financing, the toughest choice may be where to start. Typically, a business buyer should first consult with trusted advisors such as attorneys, accountants and investment bankers who have experience with acquisition financing. The sooner a purchaser begins planning for the possible financing of a transaction, the better.

Mark Pittman is the managing director of Grandview National, Inc. an investment bank that represents clients seeking to sell or acquire businesses with valuations between $1 million and $50 million, a market that is underserved by traditional investment banks and business brokers. *All rights reserved, Grandview Holdings, Inc. 6701 Center Drive West, Suite 710 Los Angeles, CA 90045 T: 310.499.4810 F: 310.499.4820.*