The Exit Strategies Newsletter

Financing Your Exit Transaction

Business owners who are looking to turn their illiquid business into cash will often ask, where will the money come from to fund my buyout? This question applies to both internal transfers to managers, employees and family members as well as to external transfers to outside buyers. The owner who is well informed as to the details of the pending exit transaction is well prepared to have meaningful and intelligent conversations about where the cash will come from to fund their exit. After all, as the old saying goes, if you want the answer to a lot of your questions, 'just follow the money'. So, let's take a look at the types of capital available and what type of buyer would attract, have and / or deploy that capital to buy your business in the future.

General Comments Regarding Capital Flows

It is important to know and remember that capital flows in and out of markets in a manner akin to how tides flow in and out. At times capital is in abundance because lenders and other financing sources are optimistic and want to 'put money on the street'. At other times certain lenders retreat from the markets and withdraw from participating, even making 'calls' on the outstanding capital that they have extended. The most recent recession was a classic example of financing sources retreating from markets during a time of turmoil and uncertainty, withdrawing or otherwise restricting credit facilities with owners and / or calling in their outstanding loans and / or withdrawing from financing buyouts all-together.

Now, not all capital behaves in this manner, as this newsletter will more fully describe.

Strategic Buyers with 'Cash on the Sidelines'

Our first source of capital to examine is the cash that is 'sitting on the sidelines' of corporations around the world. While we seem to be at a point in time where the recession seems more behind us than in front of us, there is a record level of cash sitting on the sideline of publicly-traded companies. Now, theoretically, this cash should either be put to work either in internal / 'greenfield projects' or it should be returned to shareholders in the form of a dividend (or, alternatively, through the repurchase of outstanding shares).

Now, today's CEO has the cash but is still gun-shy about deploying it in the form of acquiring other, smaller, businesses.

That being said, it appears as though the cash really only has one place to go because managers do not want to 'return cash to shareholders' – they'd rather build their empires with meaningful acquisitions. If you can get a strategic buyer to pay you cash for your business, then you don't need to ask too many more questions. The cash is available, they want to buy your business, you just need to negotiate for the right prices and away you go [. . . if it was only that easy . . .].

Senior Bank Debt

You may find that a future buyer of your business wants to fund the acquisition by borrowing from a bank. Banks are open to this type of business and many will finance the acquisitions for certain buyers who do not have the cash (or perhaps some who do have the cash but, for corporate finance and other reasons they prefer to borrow to purchase your business). And banks are the classic example of capital that flows in when markets are good and flows out when markets are bad.

Now you may be thinking, that's all great but it's the buyer's problem to get the financing. That is only partially true. You see, it is actually a bank's willingness to lend into acquisition financings that, in the aggregate, will drive demand for business acquisitions and, hence, impact the value of your company and the price that you receive. As a follow up point, if you are receiving any portion of your sales proceeds in future payments such as deferred note payments and earn-outs, the assumption by your company of large amounts of debt (which of course needs to be paid back) may impact the future viability and manner in which your company is run.

It is helpful to know that your buyer knows that senior bank debt is limited. Banks will not loan 100% of the value of a business to a buyer and not all buyers will qualify for this type of financing. Senior debt is a low margin business with no upside potential and which is heavily regulated. These three (3) factors combined will limit your buyers' overall access to this type of debt (particularly depending upon market conditions) and will impact what a buyer can pay for your company.

Private Equity

Moving past debt, we now examine the world of private equity. In this world, private equity groups ("PEGs") of which there are thousands in the United States alone, have capital that is targeted for acquisitions of privately-held businesses. In fact, the entire reason for a PEG to exist is to purchase (and perhaps later sell) private companies. This 'equity' capital is far different than debt capital primarily because it does not need to be re-paid. In this regard, equity comes into the company, making for a stronger balance sheet than heavy amounts of debt. Now, don't be fooled by private equity entirely because the truth is that while PEGs have capital available to make acquisitions, they generally prefer to also borrow senior debt, in addition to the equity that they contribute to the deal, to finance the acquisition. In this regard, the senior debt markets can, and likely will, continue to impact the pricing and overall structure of your deal.

Private equity, however, is long-term capital. PEGs know that they may not get their money / equity out of the business for many years (perhaps 5 to 7 years). Further, this is risk capital in that if the company fails, it is generally the debt holders who are repaid first (i.e. have a first lien on the assets of your business). That being said, private equity is a heavily incentivized business model with a lot more upside than senior debt capital. The private equity groups are compensated for the additional risks that they take because if the company does well, they repay the debt, own the majority of the business and will re-sell the company for a high profit over what they paid you to buy it from you. Because of the model of private equity investing, this form of capital does not ebb and flow like debt financings. Once PEGs are invested in a company, they are partners in that business, tied and vested in the company's future success.

Mezzanine Financing

Between Debt and Private Equity sits a hybrid form of financing called mezzanine debt. The reason that mezzanine capital is a 'hybrid' is because it has attributes of both equity and debt. In fact, the capital is structured in the form of a high-interest, subordinated [to the senior debt] loan. The mezzanine capital also will, in most cases, have an equity component called a 'warrant' which provides some upside potential to the 'mezz debts' overall return. Mezzanine debt works mostly with private equity and senior debt as 'bridge capital'. Mezzanine debt will invest in riskier projects than senior debt (because they have a higher return potential) and will 'bridge' the financing structure where a buyer does not want to fill it with equity.

Concluding Thoughts

As an owner who is thinking about an exit, it is in your best interest to treat your future buyer's financing sources and availability the same as if they were your own issues and problems to solve. By understanding the sources of capital that your buyer may have access to, you may be in a position, prior to your exit, to impact the way in which your buyer can access different levels of capital. By taking on this role and responsibility, you are increasing the odds that you will have a successful exit.

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