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How to finance an acquisition

Some art and some science are involved in structuring a desired deal and obtaining funding for an acquisition.

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by Kenneth H. Marks

Conventional wisdom says that a company grows by reaching new customers, increasing its workforce, expanding marketing, or launching new products or services. These are important ingredients to achieve growth. But the perhaps unconventional truth is that this kind of growth can be riskier and less compelling to investors than growth through acquisition. In fact, synergistic acquisitions—ones that reap rewards beyond just combining two enterprises—can bring middle-market companies other significant benefits, including rapid growth, increased market share, and economies of scale. And, namely, they pique the interests of those in the private capital markets.

Investors and lenders in the private capital markets today have abundant, relatively cheap capital for companies that have their financial houses in order and are looking to grow. Companies that have identified an acquisition target with proven earnings and a foreseeable return on investment might have an easier time obtaining financing.

Think of financing an acquisition as an exercise with two parts that work in concert: (1) structuring a desired deal with a suitable target and (2) obtaining the funding.

Structuring the desired deal

A desired deal is one that is engineered specifically with the big picture in mind. Begin by shaping your acquisition plans out of a long-term growth strategy and align the terms with what's required to successfully integrate the target company. Set clear financial objectives for an acquisition and create benchmarks to gauge attractiveness of potential target companies. To keep your team (management and advisers) from getting emotionally overcommitted to a specific business, carefully balance the price being offered for the target, the strategic problem or opportunity it addresses, the likely near-term cash flow of the target, the integration strategy, the inherent risks, and the deal structure.

Valuation is almost always a priority issue for everyone involved, but keep in mind that the structure and terms of the transaction are just as important. Value the target acquisition as a stand-alone business first. Then value the acquisition in the context of your business, giving consideration to the likely cost savings and potential revenue lift that can result from combined capabilities.

A desired deal meets the needs of the buyer, the seller, and the funding sources. Be open to the iterative nature of the process, allowing lessons learned and market information to continually refine and shape the acquisition plan. The desired deal is built out of the synchronization of six essential elements.

- **Closing cash**: A common mistake is to fixate on the cash needed at closing and overlook other investments required to fully combine two businesses; at the very least, be sure to consider integration costs.
- **Working capital**: Identify the additional working capital required to achieve your plan's objectives. Growth scenarios or turnarounds and fixes often require an infusion of cash beyond the cost of the acquisition.
- **Debt payout**: Understand the debt you will assume in the transaction. What is the implication to your future cash flow, and what is the timing of payout?
- **Leverageable assets**: Consider assets that you can leverage or borrow against. Typical ones include inventory, accounts receivable, and fixed assets. You might consider intellectual property and real estate, too, especially where their true value isn't represented on the balance sheet.
- **Valuation gap**: Assume there will be a difference between what you want to pay and what the seller is requiring to do the deal; consider bridging this with an earnout or a seller note.
- **Synergies**: These are welcome outcomes, but don't bet the farm on them. Synergies might include new revenues, reduced costs, or the generation of cash for debt repayment or to fund some of the transaction's integration costs. Synergies could lead to increased earnings before interest, taxes, depreciation and amortization (EBITDA) and real value creation. Structure the deal so that the acquisition works by simply continuing the performance of the businesses as is; 1+1=2 is still a positive outcome. Use the potential impact of the synergies to fund contingent amounts such as an earnout or a milestone payment.

In an illustration of the impact of a desired deal, a U.S.-based research company acquired a smaller, niche company in Europe to fulfill its growth strategy. By synchronizing these six elements, it realized several advantages, including gaining access to new customers and new capabilities in that region and attracting a financial backer that provided acquisition and growth capital to boot. The smaller company's strong technological foundation and distinct research focus worked to expand the buying company's area of research expertise and technical know-how. The integrated capabilities meant that the combined company could negotiate bigger contracts on a global scale with greater credibility and, ultimately, accelerate growth and significantly increase the value of the combined businesses. The transaction was structured to pay for existing value as evidenced by the historical financials and business backlog and to compensate the sellers for operational execution and future growth.

Obtaining the funding

Of course, few deals go down without funding. It's wise to establish a financing plan and address the capital structure after you can clearly articulate the company's business plan and delineate how much funding is required, how it will be deployed, and when it is needed. The final answers to these are often outcomes from structuring the deal as discussed above.

Unless your company has the capital on hand to fund the transaction, test the planned deal with funding sources before committing. This increases the chances of closing the desired deal and obtains a soft buy-in from the investors and lenders. Think about the whole capital structure and the impact to the various layers of financing.

Many acquisitions in the middle market require a combination of senior debt and some type of equity or quasi-equity such as mezzanine financing. In deciding on the right capital structure for an acquisition, shareholders and management must balance the risk of default in repaying debt with the availability of equity capital to pursue growth opportunities. If a company is too conservative and does not leverage its equity to provide increased capital to invest, it may miss market opportunities and ultimately erode the overall value of the business by becoming a lesser player in the market. However, being too aggressive and overleveraging the company may lead to weak financial performance and business failure when things do not go exactly as planned.

As part of the acquisition process, be sure to develop a sound financing strategy in which you:

- Determine the current and potential valuation and financial strength of the acquisition target.
- Measure the projected performance against your financial objectives and benchmarks.
- Set boundaries on how much your company is willing to invest based on the risk profile of your shareholders.
- Establish relationships with financing sources and secure buy-in for your acquisition and financing plans.
- Gather evidence of your ability to finance and close a deal to present to potential sellers.
- Maintain a keen focus on value creation.

Once you have a financing strategy in place, securing capital from lenders and investors requires your team to have and show a strategic rationale for the deal, the ability to integrate the acquisition, a clear vision for the post-closing operation and its competitive position, and a realistic illustration of making debt repayments and creating a return on the investment for new investors and existing shareholders. Structuring your transaction on the six spokes of a desired deal will drive to completion an acquisition that is strategically and financially beneficial.

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