

## **Look for financing *now* – before you have an acquisition target**

You've found your ideal acquisition target — a reasonably priced company that you believe will provide cost synergies and new markets for your products. Now it's time to find financing for your acquisition, right? Wrong. The time to line up financing is before you start looking for a business to buy.

### **The early bird**

Early preparation will help you identify the price range of businesses you should be targeting and the approximate financial health required of an acquisition. Knowing how much funding you'll likely need from outside sources can also help you evaluate potential risks — before you assume substantial debt and other obligations.

Starting your search with financing already secured will further strengthen your position as a credible buyer and eliminate the embarrassing possibility of needing to cancel your bid because of a financing problem. In fact, positioning yourself with the seller as a well-qualified buyer could make the difference between a deal and no deal. After all, the seller won't have much incentive to allow you to get to the due diligence stage if your financing ability is in question. And having already lined up financing could be important if you're competing with other prospective buyers.

### **4 main sources**

Prospective buyers, depending on their goals and resources, could consider these main sources of financing:

1. Private equity firms,
2. An initial public offering (IPO),
3. Seller financing, and
4. Banks.

If you want to retain full control of your business, you should probably rule out a private equity firm or IPO. While both offer certain advantages, they require you to transfer equity to outsiders.

Seller financing can be beneficial, especially if you can't find financing elsewhere. But of course you won't know if it's available until you're actually in contact with an acquisition target.

So if you want to line up financing before approaching potential acquisition targets, bank financing is a convenient, cost-effective alternative. The best place to start is your own bank, where you already likely have a good working relationship. If, however, your bank doesn't understand your business or industry, or doesn't often finance acquisitions,

consider finding another one that's better suited to your long-term growth needs. Many banks specialize by industry, so investigate your options and take the time to find a lender that understands your company.

### **Collateral**

A bank that's interested in working with you will first look at your 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. To determine how much to lend, the bank will review 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.

Bankers don't make loans unless they're comfortable with their collateral in the event of default and the borrower's ability to meet borrowing costs. For this reason banks often ask for personal guarantees from owners of small and midsize businesses.

### **Cash flow**

The bank will also look at your 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.

The interest rate you receive depends partly on the ratio of your EBITDA to your 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 your interest rate. The interest rate for small to midsize companies is typically one to two percentage points over the prime lending rate.

### **Closing the deal**

Once you've identified a financing source 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 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 about proceeding. 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, by having financing lined up beforehand, you'll reduce the possibility, however remote, that your bank will significantly delay financing approval — or even deny the loan at the last minute. Any issues your bank may have had with your assets or cash flow will already have been addressed.

## **Improving the odds**

Occasionally, acquisition opportunities appear when you aren't expecting them, and you must scramble for financing after you've identified a target. In most cases, however, you have time to plan ahead and complete this crucial step early in the process — strengthening the chances for your deal's success.

### **Sidebar: ESOPs: An alternative funding source**

An employee benefits plan may not seem like the most obvious way to raise cash. But Employee Stock Ownership Plans (ESOPs) can be an attractive financing source for companies making an acquisition.

ESOPs are defined contribution retirement plans that invest primarily in their own company's stock. Like traditional profit-sharing plans, the sponsoring company makes tax-deductible contributions to the ESOP for the benefit of participating employees. Unlike traditional profit sharing plans, however, ESOPs may borrow to purchase stock from the company's shareholders or newly issued stock from the company — enabling the company to raise needed capital.

ESOP loans offer tax advantages and can be more desirable than traditional loans when it comes to cash flow. Drawbacks, however, include additional corporate governance and administrative costs and ERISA-mandated annual valuations.