

Sellers should be prepared as M&A market recovers

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Many owners have been frustrated when trying to sell a business during the last two years. With the dearth of credit and depressed operating results, even owners with the most carefully planned exit strategies have been stymied. Buyers pretty much disappeared with the lenders, and would-be sellers retreated from lower valuations to attend to their ailing businesses. Last year was the worst for merger-and-acquisition activity in a decade.



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This year is already looking stronger than the last two. Credit is trickling back to the market. However, a stronger market in 2010 is no return to 2007 conditions for sellers. It's still a buyer's market. Sellers entering today's M&A market must take extra steps to make their companies attractive.

Today's buyers still look first for the seven drivers of core value:

- A strong and dedicated management team.
- Strong gross-profit margins.
- Recurring cash flow.
- Opportunities for growth.
- Defensible market position.
- Proprietary technology, processes and knowledge.
- Strong brand awareness.

Once those drivers are addressed, owners and their advisers can add value by removing obstacles that could hinder a transaction's closing.

Financing is a good example — it's still one of the biggest transaction risks. Buyers with access to capital are much more likely to close than buyers without. Likewise, financeable companies are more attractive to buyers than those more difficult to finance. A seller who successfully eliminates or reduces the financing obstacle creates a valuable competitive advantage and increases the chances for a successful transaction.

Removing the financing obstacle begins with the seller viewing the transaction from the buyer's perspective. The best way to do that is for the seller to determine what capital structures and sources will allow a qualified buyer to acquire the company — at an acceptable valuation for the seller. That strengthens the seller's negotiating position and provides valuable information and relationships to help buyers complete the deal.

Sellers could receive cash, seller notes, earnouts and stock for their company. While seller notes, earnouts and stock are often important components of the purchase price, they are the least likely to hinder a transaction. These instruments are created by mutual agreement between buyer and seller. The cash portion is the potential deal wrecker.

The big question is, where will the cash come from? Here are some funding sources that buyers may tap for that part of the purchase price:

•**Cash on hand.** Tighter credit conditions require buyers to put more of their own money at risk. A recent Standard & Poor's report found for leveraged buyouts involving companies with earnings of \$50 million or less before interest, taxes, depreciation and amortization, equity represented 51% of the purchase price. That's up from only 33% in 2007.

Tip: If the buyer plans to use third-party financing in the transaction, the seller should make sure the buyer has their portion of the financing in-hand.

•**Senior lenders.** Senior debt is generally provided by banks and other financial institutions. It is collateralized by a first lien on the current and long-term assets of the company. S&P says senior debt was 2.5 times EBITDA 2009 (down from 3.6 times EBITDA in 2008). The multiple drops for companies at the lower end of the EBITDA range.

Tip: Many community banks are more active than larger banks in this type of lending and may be a good source of acquisition financing.

•**Asset-based lenders.** This type of senior lender specializes in providing secured loans backed by assets such as accounts receivable and inventory. These lenders ordinarily base loan limits on a higher percentage of the collateral value than banks and other commercial lenders do. They may loan up to 85% of accounts receivable and 65% of inventory.

Tip: If accounts receivable and inventory represent a large part of a company's value, calls to two or three asset-based lenders will determine their appetite for a company's business and potential as a cash source for a buyer.

QUICKINFO

FINDING BUYERS

- Business owners** looking to sell are finding a thawing market.
- The cash portion** of a transaction remains a key consideration for both sides.
- Buyers have** several options to raise cash, but the cash share of the purchase price has risen from a couple of years ago.

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•**Mezzanine (subordinated) debt lenders.** Subordinated debt is generally obtained from insurers, finance companies and specialized funds. This is the portion of financing between a company's senior debt and equity, and is subordinate in priority of payment (and claim on assets) to

senior debt. Sub-debt averaged 0.7 times EBITDA in leveraged buyouts in 2009. Loan amounts are based on cash flow available for debt service, not collateral values. The use of subordinated debt has increased in recent years to help fill the void left by senior lenders.

Tip: Mezzanine loans are not for every company and are difficult to find for companies with EBITDA less than \$3 million. When available, such loans can serve a valuable role in closing a financing gap in a transaction.

•**Earnouts, seller notes and equity.** Presumably easier to source, earnouts, seller notes and retained (or rollover) equity are the portion of a buyer's capital structure that sellers resist the most. A buyer's desire to share risk with a seller directly conflicts with the seller's aversion to risk. In spite of this inherent conflict, these instruments are frequently the key to bridging a gap between a seller's goal for a higher valuation and a cautious buyer's concerns about overpaying.

Tip: Sellers should expect to receive part of the sale price in a form other than cash paid at closing. The terms of these instruments can vary widely. The details require careful consideration.

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