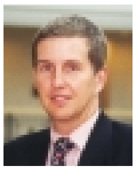
THE RIGHT APPROACH TO FUNDING



WHEN IT COMES TO ACQUISITIONS, MAKING THE RIGHT MOVES IS CRUCIAL TO SUCCESS. THE TIP IS, SAYS **IAN HOWEY** OF FORTIS BANK, TO ENSURE YOU DON'T CUT ANY CORNERS.

In this article, I will outline some of the funding options that businesses should consider in undertaking an acquisition and set out some key factors that will contribute to making acquisitions a success.

FUNDING STRATEGY

First, it is true that the funding strategy is likely to be influenced by the type of deal involved. Some of the contrasting types of acquisition you might be contemplating are:

- **An acquisition or management buy-out (MBO) or buy-in (MBI).** An MBO or MBI generally involves a single organisation, hopefully with a decent track record of underlying profitability. If the target business itself cannot generate sufficient cash to service the funding used to buy it, then there is a problem. Contrast this with a company identifying and buying a third party target. The target may be profitable in its own right, but it does not need to be because the acquirer will have the benefit of its own profits, cashflows and balance sheet to add to the equation.

- **Hostile or friendly?** Are you competing with other buyers or do you have exclusivity? This may affect your ability to gain access to information on the target and the ability to utilise the target's own funding resources. It certainly may rule out any form of vendor finance.

- **Start of a 'buy & build'.** If you see your acquisition target as the first in a chain of possible consolidation, then the funding strategy needs to take account of the long-term picture and not just the immediate deal on the horizon.

Other factors that need to be taken into account are:

- **The state of the acquirer.** Are you sitting on a cash-rich business or one that has already leveraged itself to the maximum amount possible? Are you an asset-rich company, and are those assets attractive to asset-based funders?

- **The state of the target.** A highly-geared target has implications for how much the vendors can expect to receive after clearing its borrowing, but this is not necessarily your problem as the acquirer. The ability of the business to generate profit and cash under new ownership is the key to using the target business to raise finance against it.

- **The potential of the combined entity.** Most acquisitions are driven by the benefits of combining two businesses, whether those benefits arise simply from economies of scale, removal of cost duplication or maybe a new route to market. If there is considerable upside and you can demonstrate it then a whole new level of funding may be available to you. However, be warned, you may well have to share some of that upside and you should expect a healthy degree of scepticism about this part of the plan from the funders you talk to.

- **Reason for the disposal.** The reason for the disposal could impact on the price you are asked to pay and when you are asked to pay it. A vendor in financial difficulty trying to raise cash from disposals is not likely to accept deferred consideration.

SOURCE OF FUNDS

So far, I have been talking in general terms about funders and funding. But who are these funders, what will they provide and where do you find them?

BANK FINANCE

In terms of facilities, we are looking mainly at traditional forms of bank finance. This means senior debt and working capital at its simplest. However, you may want the flexibility of revolving credit facilities or specific projects may warrant capex lines. Finally, as the amounts become more aggressive, there is the possibility of using mezzanine finance.

IS THERE A DEBT APPETITE FOR THE DEAL?

If there is an established track record of profitable trading then there is almost certainly a debt capacity. How much depends on the results of an in depth business risk assessment. This assessment exercise all falls under the general description of due diligence – a gradual and potentially frustrating process sometimes referred to as 'peeling the onion', as layer by layer the target reveals itself.

These due diligence factors will all influence the fine tuning of the debt package, but there are a number of even more fundamental key parameters that the debt package will normally be expected to fall within, and these represent the boundaries of senior debt structuring:

- Debt to Ebit multiple;
- Debt vs equity split;
- Debt repayment profile;
- Interest cover; and
- Cashflow cover.

These parameters come under the microscope during detailed financial modelling and sensitivity analysis on the business plan numbers. It is essential that you understand what your business can prudently stand under each of these category headings and what the funders will regard as acceptable. Apart from bank funding, other forms of funding that may be available are:

- **Asset finance.** Sometimes used alongside bank debt as part of an acquisition package. More often asset finance is looked to as a source of working capital for the ongoing business.

- **Equity.** Equity contributions towards acquisitions can come in many forms including the acquirer's own cash resources. Don't overlook the obvious, your own cash resources are likely to be the most accessible source of funds and probably qualify as the cheapest and the lowest risk. At the same time be careful. At the very least, the consent of existing lenders may well be required before cash is used for an acquisition.

  The management team might subscribe for a modest amount of equity themselves. This is particularly the case in MBOs.

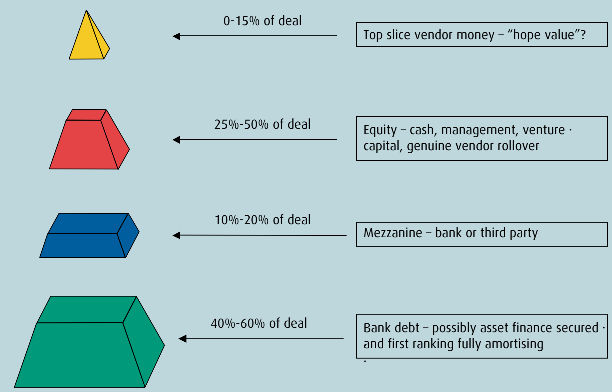
  More significant private equity may be available from a business angel or investor club (at the smaller end, of up to £500,000) or from a wide choice of private equity firms or venture capitalists.

  To those businesses of sufficient critical mass, the public markets, of course, remain a potential source of funds, although the general feeling is that new share issues, even on the AIM market are, for the time being, not a serious option.

- **The vendor.** It is becoming increasingly common to see transactions completed with the assistance of funding from the vendor themselves.

  A vendor genuinely re-investing a proportion of the sale proceeds to reduce the amount of funding to be raised can be a positive way of overcoming difficulties in attracting venture capital. But be careful, the ongoing involvement of the vendor can have the opposite effect and might stifle the new management or even cast a shadow over their ability to manage the business independently. Also bear in mind that deferring some of the consideration often addresses a difference in opinion over what a business is worth – and, but for the vendor

THE DEAL PYRAMID



In diagrammatic terms, the funding structure of a deal can very simply be built up as show in the above chart.

It may be becoming apparent from the various sources of funding that can be involved in a deal that each of them represent some sort of comment on the price that is being paid for the target.

If a management buy out (MBO) has been funded entirely with senior debt than you have probably got a knock-down price – possibly for a good reason. If a debt and equity package has been enhanced with a slice of vendor deferred consideration it may be a sign that you are over-paying.

Is overpaying for a business terminal? In my opinion, not necessarily, and provided the deal is structured properly, it certainly should not be terminal for the senior lender. The most likely outcome if you pay too high a price for a target is that the returns of the equity holders, including management, are seriously reduced on exit.

A more serious issue from the bank's perspective is if the deal has been too highly funded with debt. This will also be an issue for any subordinated lenders or investors in the deal because if the servicing of debt comes under pressure then the lower ranking slices of finance will almost certainly find their yields switched off.

agreeing to some delay in receipt of proceeds, this would have represented a funding gap.

Vendor-assisted transactions are relatively new and the long-term success of them – by which I mean successful exits for all parties – has yet to be proved.

MAKING A SUCCESS OF THE ACQUISITION

Shortly after completion of an acquisition, and what always seems to be a difficult and lengthy process, comes the realisation that this is actually just the start of delivering the plan!

Speaking as a funder, delivering the forecast trading results is always a good start to making the acquisition a success, but the only absolute certainty on day one is that things will not go exactly as planned. I would encourage you to get a good open dialogue with your bankers and investors from the start. Be upfront with developments – the bad ones, as well as the good, and show that you can respond appropriately.

Establishing this rapport with external funders is an extension of getting the board structure right internally – address the important issue of corporate governance from day one. Make an honest assessment of people's abilities and don't back away from acknowledging that some of the current team may not be up to a more demanding role.

Where appropriate, incentivise key managers in the organisation with the prospect of equity participation in the business.

Pick the low-hanging fruit first. In other words, tackle the easier wins first and make sure the acquisition has bedded down first before tackling a relocation with simultaneous replacement of the key computer systems. Better advice might be never to tackle a relocation at the same time as the replacement of the key computer systems. All of which are post-deal items that may or may not help to make the acquisition a success. In my opinion, however, this misses the main point, because the success or otherwise of any acquisition starts the day you identify the target, agree the price and prepare the forecasts.

'THE ONLY ABSOLUTE CERTAINTY ON DAY ONE IS THAT THINGS WILL NOT GO EXACTLY AS PLANNED'

If you really want to make a success of acquisitions:

- choose targets with care;
- be ruthless in assessing whether to proceed;
- set realistic and achievable forecasts and choose experienced partners to back you; and
- don't overpay.

Plan carefully, because if you over-promise on price or performance, you will end up being over-funded and can only under-achieve.

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