Insights

Methods of Financing an Acquisition
M&A Basics Series – Article 6

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This article provides a quick summary of some the more commonly used methods that companies use to finance their M&A activities including (1) using available cash, (2) obtaining a new or amended credit facility, (3) obtaining mezzanine debt financing, (4) exchanging stock, (5) raising equity financing, (6) accessing public debt financing, (7) obtaining a bridge facility, (8) utilizing vendor take-back financing and (9) negotiating earn-outs.

Available Cash

If the buyer is generating significant excess cash from operations, it may use that available cash to finance an acquisition.

Or the buyer may have room under its existing credit facility and may draw down on that facility to finance an acquisition.

New or Amended Credit Facility

Alternatively, the buyer may negotiate a new or amended credit facility with its lender, close that new or amended facility concurrently with the closing of the acquisition and draw down on that new or amended facility at closing in order to finance the acquisition.

Mezzanine Debt Financing

Buyers sometimes use “mezzanine debt” to finance acquisitions. Mezzanine debt capital generally refers to that layer of financing between a company’s senior debt and equity, filling the gap between the two. Structurally, it is subordinate in priority of payment to senior debt, but senior in rank to common stock or equity. In a broader sense, mezzanine debt may take the form of convertible debt, senior subordinated debt or private “mezzanine” securities (debt with warrants or preferred equity).

When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity required in the business. As equity is the most expensive form of capital, it is most cost effective to create a capital structure that secures the most funding, offers the lowest cost of capital, and maximizes return on equity.

Exchanging Stock

Many public companies prefer to use their shares as currency when completing an acquisition and will issues shares in their own company from treasury in exchange for the outstanding shares of the target company.
**Equity Financing**

Where the seller wants cash and the buyer wants to issue equity, the buyer might raise the money to finance the acquisition by selling additional equity in the company to third party investors. This can be done in a “public offering” through investment banks or in a “private placement” using exemptions from the prospectus requirements (and with or without the help of investment banks).

In circumstances where there may be a significant period of time between the time of the financing and the closing of the acquisition, a buyer may choose to issue “subscription receipts” instead of common shares. A subscription receipt is a security that is automatically exchanged for a common share upon the closing of the acquisition. The cash raised from the sale of the subscription receipts is held by a trust company and invested in short-term high grade debt securities or interest bearing deposits until closing. If the acquisition does not close within a pre-determined period of time, the cash plus the interest accrued is returned to the investors. Note that that the underwriters typically receive 50% of their fee on the closing of the financing and the balance on the closing of the acquisition.

**Public Debt Financing**

Rather than issuing equity, the buyer may choose to issue bonds or debentures to third party investors. These may or may not be convertible into common shares, secured against the assets of the company, or subordinated to other forms of indebtedness. For example, a common form of debenture issued by a public company is a “convertible, unsecured, subordinated debenture” with interest payable in equal semi-annual instalments and the principal due on maturity.

In circumstances where there may be a significant period of time between the time of the financing and the closing of the acquisition, a form of debenture similar to a subscription receipt has been developed called an “extendible debenture”. These debentures typically have a very short time to maturity but the initial maturity date is automatically extended to the agreed upon term upon the acquisition closing. If the acquisition does not close prior to the initial maturity date, the principal plus the interest accrued is returned to the investors.

**Bridge Facilities**

A buyer may obtain a “bridge facility” from a lender to bridge the gap between the time of the closing of the acquisition and the time that replacement financing can be sourced. Often the bridge facility will be broken into separate facilities for each source of financing that is contemplated to replace the bridge facility (i.e. equity bridge, debt bridge, asset sale bridge, etc.) and the cash obtained by the buyer from the specified source must be used to repay that component of the bridge facility. Bridge facilities are structured to incentivize quick repayment/replacement (i.e. higher interest rates, penalties, etc.)

A seller will typically prefer the buyer to obtain a fully committed (i.e. unconditional) bridge credit commitment concurrently with the execution of the acquisition agreement. Where the lender is unwilling to do that, a buyer may seek to obtain a credit commitment with a “Sungard provision” where the lender’s conditions to advancing funds mirror the buyer’s closing conditions in the acquisition agreement. However, more commonly, a lender will want to do its own due diligence before advancing funds and will insert a more broadly worded “lender approval” as a condition to advancing financing and the acquisition agreement will include a broad “lender approval” condition.

**Vendor Take-Back Financing**

Where the buyer cannot access financing from traditional sources at affordable rates, and where the seller is motivated to sell, the parties may agree that some or all of the purchase price may be paid in the form of a “vendor take-back” financing. This is an arrangement where the seller “loans” the buyer
part of the purchase price for the business – in effect it lets the buyer pay the purchase price over time. The amount of financing, the security, the payment terms, the frequency of payments, and the interest rate of the vendor take back financing are negotiated between the parties.

**Earn-outs**

Where the buyer and the seller cannot agree on the value of the business at the time of closing, or where the seller will remain with management and the buyer wants to further incentivize the seller, they sometimes agree to an “earn-out” provision. This typically provides for the seller to receive additional payments upon the achievement of certain future performance criteria (i.e. revenues) by the acquired business.

**Invitation for Discussion:**
At Shea Nerland LLP, we have a wealth of experience as legal advisors on M&A transactions, both large and small, and understand the many financing alternatives that buyers can utilize to advance their acquisition strategy. If you are contemplating buying or selling a business, please do not hesitate to contact one of the lawyers in our business law group. We would be happy to assist you on this exciting journey.

**Disclaimer:**
*Note that the foregoing is for general discussion purposes only and should not be construed as legal advice to any one person or company. If the issues discussed herein affect you or your company, you are encouraged to seek proper legal advice.*