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Credit Crisis: What Does It Mean To Mid Market M&A

Impact of Tight Credit Markets on Business Sale Transactions

"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." - Warren Buffett

Until about a year back, life in the mid-market M&A lane was somewhat predictable. Most companies entering the deal making process had respectable growth rates, rosy outlooks, and credit was plentiful. Private Equity Groups and lenders had access to money they could put to use on the right deal. More often than not, the sticking point in the deal was the valuation.

All that changed in the last year. As we approach the end of 2008, most businesses are finding that the environment has changed dramatically. A business owner looking to sell is typically in a situation where the trailing 12 month numbers look less than attractive, business outlook is no longer rosy, and credit is extremely tight. The view for the acquirer is not much better. Valuation is not the biggest sticking point any more. Even if the acquirers think they have negotiated an excellent bargain, financing the acquisition is highly problematic.

By some estimates, the value of business deals year to date has dropped by about 35% in spite of a large volume of unexpected distress deals. Excluding the distress sales, total transaction values appear to have plummeted by as much as 50%. In appears that one out of two business sale transactions is not materializing largely due to the liquidity crisis.

Unfortunately, the end is not in sight. In spite of the intervention of the government in the recent past, credit is unlikely to be plentiful for the foreseeable future. Optimistic forecasts call for business trends and transaction dynamics to remain unfavorable until the second half of 2009. So, how can sellers and acquirers facilitate a meaningful business sale transaction in the interim?

The answer, while not the most optimal, is surprisingly simple! If lack of liquidity is the problem, then providing or facilitating liquidity is the solution. There are several ways in which sellers can provide or facilitate liquidity in a business sale transaction:

1. Structuring the deal to reduce third party debt in the deal: This can be done by increasing the money required upfront, taking part of the transaction amount in the deal as earn-outs, retaining part of the equity post-acquisition, increasing the payout time on deferred monies, and other mechanisms that defer the payment schedules. Due to the inherent risks of this approach, extreme care should be taken in inking the terms of such a deal.

2. Separating asset types for hybrid financing: This can be done by separating asset types (real estate, inventories, receivables, etc.) and finding an optimum way to finance each of the elements. For example, the real estate component could be done in a separate lease-buyback transaction or inventories could be financed by creative lender financing.

3. Seller financing: While it is not possible in every instance, to the extent possible, sellers can float the required credit to the acquirer. The biggest disadvantage of this approach is that the acquirer's failure in operating the business can result in a dramatically reduced return to the seller.

4. Seller loan guarantees: Liquidity can also be facilitated by sellers guaranteeing third party debt in the deal. This approach could potentially reduce the seller's liability substantially compared to the previous scenario but otherwise is similar in many ways.

With these deal structures, the seller's vested interest in the deal, post-acquisition, increases dramatically. The biggest risk in any of these approaches is that the acquirer's ability to make payments will depend on the future success of the business. The acquirer may mismanage the company, or the economic conditions may become more unfavorable, or some other unanticipated event could dramatically reduce the acquirer's ability to pay down the obligations. Sellers should be cognizant of the risks in these approaches and take precautions to mitigate the risk and improve the return.

On the upside, there are some significant benefits to the sellers. Empirical data indicates that if a seller can assist in financing the deal, the deal value can improve as much as 40%! The deferred payment stream could also result in substantial tax benefits to the seller. Another major advantage of this approach is that the sellers would very likely be able to negotiate a higher rate of return on the deferred payments than the returns available to them elsewhere.

In spite of the sellers' preferences, sellers should also be aware that, in these tough economic times, acquirers and lenders prefer these deal structures and some may even require them.

From a seller's perspective, proceeding down this path should be done carefully with enormous attention being paid to the caliber of the acquirers, deal terms, and collateral support for the payments. A backup insurance facility to further mitigate the risk may also be necessary in special cases.

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