Asset/ Share Deals + Financing M&A

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Asset Deals/ Share deals + Financing Transactions

M&A Transactions: Share Deals, Asset Deals and Legal Mergers and Divisions

Share deals: An introduction

Before I will look at "asset deals" and "legal mergers and divisions", I will look at "share deals".

In M&A the most used structure is a share deal.

Actually when we are talking about acquisitions, it is almost normal to assume that we talk about a share deal.

Although a share deal actually is not really a "logical" choice from the basis.

This in a sense that with this type of transaction the "enterprise" is actually not bought.

This because the "assets & liabilities" just stay in ownership of the "legal entity".

And only the shares in this "legal entity" are bought.

So in the meantime, the assets & liabilities stay where they are, so they just stay inside the bought legal entity.

And the "assets & liabilities" (the enterprise) is bought "indirectly" with the shares.

(Source used: T.M. Stevens & S.B. Garcia Nelen, 2017)

Share deals: Continued

Advantages of Share Deals

Concerning acquisition structure, a share deal is most used because of its (relative) simplicity.

This since transferring all the assets and liabilities separately is a lot of work (like in asset deals).

And the execution of doing an asset deal carries risks, like for example risks with "taking over contracts".

This since with an asset deal contracts can only be taken over when the counterparty agrees.

A share deal also provides flexibility in order to decide at what moment the company is “economically” transferred to the buyer.

This because the "enterprise" will stay in ownership of the "legal entity", as mentioned before.

So the profits of the enterprise will flow in first instance just in to the legal entity. And then buyer and seller can decide (contractually) who is entitled to this profit.

In addition, because the enterprise does not change ownership (since it just stays within the same legal entity), no re-valuation of assets is needed (in principal).

Although in the end, in practise this does not work like this.

Since due to the book keeping rules (e.g. IFRS) we need to put the assets for a “fair value” on our balance sheets (purchase price allocation).

From a fiscal perspective structuring an acquisition is still an issue.

Since in an asset deal "paid goodwill" can be amortised, which results in tax benefits for the buyer.

And seller needs to pay corporate tax on the “profits of the net assets” (goodwill) and this is a disadvantage again (this is the situation in The Netherlands, where I am from).

In principle this is not the case with a "share deal" due to so called “participation exemption” (in The Netherlands).

(Source used: T.M. Stevens & S.B. Garcia Nelen, 2017)

Share deal: Disadvantages

The disadvantage of share deals is that buyer actually buys something different than what he/ she really wants.

He/ she wants to buy the “enterprise” (activities + assets + liabilities), but he/ she buys “shares” in the legal entity which holds this “enterprise”.

And because this “legal entity” is bought the buyer gets all the "rights and obligations" on this entity, no matter what they are.

Obviously he/ she can protect them-self for the risks associated with this in negotiated warranties and safeguards in the acquisition contracts.

(Source used: T.M. Stevens & S.B. Garcia Nelen, 2017)

Asset deals

An "enterprise" can also be "really" transferred.

This in a sense that another legal entity gets ownership of this enterprise (assets + liabilities + activities).

And with this type of deal all the assets and liabilities need to be transferred separately.

Advantage

The big advantage of an asset deal is "cherry picking".

The buyer can just buy the assets and liabilities that he/she really wants (obviously there need to be legal consent).

So one of the most important reasons for an asset deal is the fear of a buyer for a later claim, or legal liability, when they buy a (part of a) "legal entity" with shares.

And this can not be the case with an asset deal, because every part of the deal is separately considered and transferred. In other word, you exactly know what you bought.

Moreover, another advantage of an asset deal is that it can take place in stages, because all assets are transferred separately.

Disadvantage

As mentioned before, asset deals are a lot of work since all components need to be transferred separately.

And this also makes the transaction costs relatively high.

(Source used: T.M. Stevens & S.B. Garcia Nelen, 2017)

Legal merger and division

With a legal merger (in The Netherlands) all assets and liabilities of one legal entity go over to another legal entity.

With a legal division the same thing happens, but then for certain assets and liabilities.

But in both situations the "purchase price" contains out of "shares". The possibility to pay the "purchase price" in money is (about) impossible.

(Source used: T.M. Stevens & S.B. Garcia Nelen, 2017)

Source - Book: Fusies & Overnames in Nederland (2017). Authors: T.M. Stevens & S.B. Garcia Nelen. Ars Aequi Libri Nijmegen.

Financing a M&A transaction: An introduction

Financing a M&A transaction: Introduction

This blog is an introduction on how to finance acquisitions.

Acquisitions are financed with different finance instruments and different financing structures.

Concerning financing of companies there are actually only two types of financing:

1. Uncommitted financing;
2. Committed financing.

Uncommitted financing can be seen a revolving credit facility ("revolver") or financing of working capital.

In theory this type of financing can be cancelled by the bank every day.

And committed financing is there for a fixed pre-determined period of time.

(Goedkoop & Veken, 2011)

Types of financing

In large acquisitions multiple types of financing are used, ranging from senior debt to junior debt.

Senior debt

Financing forms with the best secured positions are called "senior debt". The instruments are usually issued by banks.

"Second lien" is a relative new product and is less used in The Netherlands (where I am from and based). Concerning level of security, issuers of second linen instruments are lower in ranking than senior debt issuers.

Second lien instruments are issued by banks and institutional investors.

Junior debt

Junior debt, or subordinated debt, are loans with the least level of security.

A form of junior debt that is used a lot is "mezzanine financing". Concerning level of security, it lies in between senior debt and equity, because mezzanine means "in the middle".

Another form of financing is PIK loans ("payment in kind"). Withing these type of loans interest is not paid in cash but added to the face value of the loan, and paid in the end.

(Goedkoop & Veken, 2011)

Buying assets or shares

When you buy the assets/ liabilities of a company the goodwill that is paid can be amortized by the buyer. And the results of the target and the buyer are automatically consolidated.

The costs (consultants) of the acquisition are in general deductible for tax, direct or on the longer term.

Because of the amortization of goodwill by the buyer, the "book profit" (goodwill for buyer) is taxed for the seller.

So it could be the case that the price of an acquisition is higher with an asset/ liabilities deal. This because of tax payment of the seller, on the profits made on the book value of the assets.

With a share deal goodwill can not be amortized for tax purposes by the buyer. And the costs (consultants) of the takeover are not deductible for tax purposes either.

(Goedkoop & Veken, 2011)

Private equity vs. a strategic buyer

In case of a strategic buyer, the bank will not only look at the possibilities to finance the target. They will then obviously also look that financing capacity and structure of the buyer.

Corporate finance consultant (or investment bankers) assess this by building a so called "M&A model" in excel.

And when a corporate finance consultant (or investment banker) assesses the possibilities for a financial investor to finance a deal they build a so called "LBO model" in excel.

These financial investors, also called financial sponsors (private equity), are used to do deals with high levels of debt. This in comparison with strategic parties who are in general more reluctant for this.

When a company takes on high levels of debt this has big influence in how to run the company afterwards.

The large levels of interest and principal that need to be paid requires a very careful monitoring of the returns and liquidity of a company.

This is why strategic parties are often more reluctant than private equity parties to take on very high levels of debt (even when this increases the return on equity a lot, the good old "leverage").

And private equity parties are far less reluctant with this because they are (relatively) masters in this game.

Buyout structure & debt pushdown

In a typical buyout; when a private equity party buys a company, often a new company is set up. These are called "Newco" which stands for "new company".

This newco takes over the shares in the company (target) and often the management also gets shares in the newco.

With respect to structuring of the financing of the acquisition, we need to look at the newco and to the operating company (this is the company bought).

And these "operating companies" are often called "opcos".

As you can imagine a bank prefers to finance a takeover at the opco level. This since these opcos actually possess the assets for production, accounts receivables, inventories and other assets.

In other words, the money is, and is made, in the opcos! So in case of a bankruptcy, the bank can sell the assets of the opcos in order to make (some of) their money back.

Because banks want to finance the money in the opcos, in most buyouts a "debt push down" is used.

This means that a part of the financing need in the newco (to pay for the acquisition) is pushed down to the opcos.

And then from here the money is paid back up to the newco through a dividend pay-out (in order to be able to pay for the acquisition).

When we look at the total financing needs in the newco, to pay for the acquisition, this consists out of three components:

- The price for the shares (market value of equity of the target);
- The level of the debt that needs to be re-financed (this is together with the equity value the: enterprise value);
- Transaction costs (e.g. investment bankers, corporate finance consultants, credit bank, lawyers, tax tawyers, accountants etc. etc.).

And this financing need is then further spread over the newco and opco(s).

(Goedkoop & Veken, 2011)

Covenants

When a bank issues "committed financing", like discussed above, than they can not call back the debt whenever they want.

But the banks still want to be able to take control when for example financial performance gets bad. And for that "covenants" are taken up in the credit agreements.

The credit agreements (LMAs) mention in this perspective covenants as "positive undertakings" and "negative undertakings".

Positive undertaking are circumstances that the taker of the debt should live up to, like certain legal rules.

And negative undertakings are circumstance that the taker of the debt should prevent to happen, like for example selling important assets of the company.

Example 1, three of the most used financial ratio covenants with acquisition finance are:

Leverage ratio:

This ratio looks at the relation of debt over EBITDA, and this number needs to be smaller than a certain number set in the credit documentation.

E.g. 6 times EBITDA with a US LBO, 5 times EBITDA with a UK LBO and about 3 to 3.5 times EBITDA with financing in The Netherlands where I live.

Interest coverage ratio:

This ratio tells something on how many times a company can pay the interest out of EBIT(DA).

Debt service capacity ratio (DSCR)

This ratio tells something on how many times a company can pay the interest + principle out of EBIT(DA).

Example 2, a few restriction-covenants that are used a lot are:

No further debt

No additional (bank) financing can be attracted without consent of the current issuing bank(s).

Negative pledge

No security-rights of assets can be given to other third parties.

Positive pledge

Security-rights of assets need to be given to the bank (the bank who issued current debt) when they request this, and when they do not have the security-rights yet.

Cross default

Banks can call back the debt immediately when the company does not pay interest and/ or principle or violates the covenants.

Dividend restriction

No dividend can be paid out to the shareholders when the company for example did not achieve certain ratio’s yet.

(Goedkoop & Veken, 2011)

Source - Book: Bedrijf te koop – Handboek voor koop, verkoop en buyout van bedrijven. Arthur Goedkoop & Ad Veken. Publisher: Business Contact. March 2011.

Introduction Kersten Corporate Finance

Kersten Corporate Finance is an independent M&A consulting firm in The Netherlands.

Deal segment: Middle sized and SME companies. So companies with an Enterprise Value (EV) of in between 2 million euro and 100 million euro @ The Netherlands and Benelux.

Activities:

1. Selling companies;
2. Buying companies;
3. Business Valuation & Financial Modelling;
4. Financing of acquisitions with bank loans and/ or private equity firms;
5. Buy & Build strategies for strategic buyers and private equity;
6. Searching & selecting acquisition targets;
7. Finding multiples for precedent M&A transactions in a certain field.

Website M&A consulting & Valuations: **www.kerstencf.nl**

Introduction Joris Kersten

J.J.P. (Joris) Kersten MSc BSc RAB (1980) is owner of "Kersten Corporate Finance" in The Netherlands, and this is an independent M&A boutique (Mergers & Acquisitions) in consulting on M&As and valuations of medium sized companies.

Joris performs business valuations, prepares pitch books, searches and selects candidate buyers and/ or sellers, organises financing for takeovers and negotiates M&A transactions in a LOI and later in a share purchase agreement (in cooperation with (tax) lawyers).

Moreover, Joris is associated to 'AMT Training London' for which he provides training in Corporate Finance & Financial Modelling at leading ("bulge bracket") investment banks in New York, London and Hong Kong.

And Joris is associated to the 'Leoron Institute Dubai' for which he provides finance training at leading investment banks and institutions in the Arab States of the Gulf. This for example at Al Jazira Capital in Saudi Arabia and TAQA in Saudi Arabia.

In addition, Joris provides lecturing in Corporate Finance & Accounting at leading Universities like: Nyenrode University Breukelen, TIAS Business School Utrecht, the Maastricht School of Management (MSM), the Luxembourg School of Business and SP Jain School of Global Management in Sydney.

Moreover, he provides lecturing at partner Universities of MSM in: Peru, Surinam, Mongolia and Kuwait. And at partner Universities of SP Jain in Dubai, Mumbai and Singapore.

Joris graduated in MSc Strategic Management and BSc Business Studies, both from Tilburg University. In addition, he is (cum laude) graduated as "Registered Advisor Business Acquisitions" (RAB), a 1-year study in the legal and tax aspects of M&A's.

Currently Joris is following the "Executive Master of Business Valuation" to obtain his title as "Registered Valuator" (RV) given out by the "Netherlands Institute for Registered Valuators" (NIRV). This title will enable Joris to give out business valuation judgements in for example court cases.

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