Alternative financing

Thinking outside the banks

Recent lending activity suggests that the credit freeze is thawing and that lenders are willing to finance some M&A deals. Several bank-financed deals were announced in August 2010, including BHP Billiton's $40 billion bid for PotashCorp., which is being made possible by six banks, according to Reuters.

But despite such encouraging signs, many prospective buyers still find it hard to get financing from typical loan sources. Banks continue to favor large, cash-rich borrowers, and are much less willing to fund the deals of smaller or less-capitalized companies. If lenders aren't interested in financing your deal or only agree to do so at sky-high rates or with restrictive terms, such as demanding full repayment if certain ratios aren't met, it's worth your time to examine the alternatives.

A hand up

Often the best alternative source is a third-party investor, such as an individual financier or a private-equity or hedge fund. Many of these players have sat out the recession and, in some cases, have cash to spare. Your company might consider, for example, offering one of these investors a minority stake in the merged company in exchange for partial deal financing.

Another increasingly popular option is seller financing, which reduces the amount of cash or debt you must pony up. Seller financing typically takes the form of promissory notes, a type of unsecured debt that you must repay over a period of three to five years.

There are some risks associated with seller notes. Typically, interest is fixed at a higher-than market-average rate, because the note is in part dependent on your future cashflow performance. So you'll want to carefully negotiate any terms that are flexible or seek other deal concessions.

The earnouts compromise

Another common solution to financing shortfalls is an earnout, where you would make payments to the seller based on the company's postacquisition performance. Earnout payments typically are triggered when the acquired company achieves certain milestones, such as sales performance goals, EBITDA targets or even nonfinancial goals, such as a successful product rollout.

What's appealing about earnouts is their flexibility. You could agree, for example, to pay 80% of the purchase price when the sales agreement is signed and the remainder via earnout payments. In other deals, you might pay only 50% of the price upon closing and pledge to pay the other half of the purchase price when the newly merged company meets revenue goals over the following three years.

Take a detour

If banks aren't willing to be part of your expansion strategy, you can generally find a way around financing shortfalls by working with your M&A advisors. In addition to seller financing and earnouts, consider nontraditional financing options such as real estate or manufacturing equipment sale-leasebacks, factoring (an advance against accounts receivable) or mezzanine financing (a lower-level debt similar to equity). Keep in mind, however, that some alternatives to traditional financing can be costly and risky.