Types of Debt Financing in M&A Deals

The Transaction Abstract Podcast (with Anna Sabiston of Prudential Private Capital)

Debt Structuring Options

You can think about debt financing options as a spectrum. You could start with cash or savings that you have, which is readily available. You know how much you have or how much you're going to need. You can also look for external funding, but generally there's a trade off with these options in terms of cost and flexibility.

The cost of that capital is really important, so as you think about a company to acquire, you have to consider what size opportunities you can pursue. That also affects the return you can expect from making that investment.

Senior Debt

What we call senior debt is money you get from a bank. Most companies have a banking relationship and they know what their bank can provide them. An institutional lender, such as Prudential Private Capital, can also provide senior debt. Generally, this is the cheapest source of outside third party money for financing a transaction. An institutional lender can be more flexible because they are not bound by banking regulations.

However, any senior lender, whether it's a bank or an institutional lender, will only lend a certain amount before the financing becomes too risky. So who provides additional capital if you need more?

Subordinated (Mezzanine) Debt

This is a hybrid of senior debt and equity security. It has components of senior debt—interest that is paid with regular scheduled frequency—but it has the greater flexibility of equity. If things don't go quite as planned post acquisition, the senior lender—bank partner or institutional lender—can pause interest payments with the subordinated debt lender. For that period of time, your security is essentially acting like equity.

If your transaction size stretches beyond what you can get from senior debt and subordinated debt, then you could consider providing equity or finding an equity partner to invest with you. Most companies will use senior debt. Then the need for mezzanine debt, junior capital or additional third party equity is driven by the opportunity and company’s need. We most often see this in a leveraged buyout, for example.

When Should You Start Thinking About Financing?

The most organized and thoughtful companies that we partner with are thinking about and understand their capital alternatives before they even contemplate a transaction. If you're in the financial seat at a company, it’s especially important to understand that.

But even more broadly, the board should understand the various types of capital available to them because it can dictate the strategic direction the business can take. If you know you can use debt or some combination of equity and the amount available to you, then instead of waiting for a book from an investment banker to come across your desk, you can be proactive. For example, if you know you have a source of capital at a certain cost, you can target 5-10 businesses that you think have real strategic value and will help you grow.

So, the most thoughtful businesses consider potential debt structuring very early, during the strategic planning phase.

In general, it takes 8 to 10 weeks to complete a financing deal. It's a lot of work, especially with financing that involves multiple layers of capital. And it's happening at the same time that you're trying to negotiate and close on an acquisition, so there are a lot of balls in the air at the same time.

Be Prepared

To borrow a more material sum of money from any bank or institutional lender requires an audit, not just a financial review—ideally multiple years of an audit. An audit can affect your cost of capital and your availability.

Every company that we partner with has audits. Oftentimes they will also have a quality of earnings analysis, which is very important. We often work with the company's management team and financial advisors to learn what the business does, its strategy, and forecast. Our goal is to understand the strategic rationale behind the M&A transaction.

If you're contemplating an acquisition, we need to layer the two companies together to understand the real opportunity. As lenders, we want to understand the equity and growth opportunity, but in case things don't go exactly to plan, we also need to know how that will affect the debt structure that we're considering.

As you move down the risk spectrum from senior debt to subordinated debt, risk increases. Any investor who is providing that type of capital is going to be more involved or do more detailed diligence than a senior lender.

Senior debt provided by a bank will have heavier amortization—a faster repayment schedule—than an institutional lender may require. If you're acquiring a business and you know you'll need to make a lot of investments in the first two or three years but you don't want to tie up all your capital for a fast pay-down, then it may make sense to partner with an institutional lender. On the flip side, that greater flexibility can mean a bit higher cost.

One thing people often don't think about is who they're partnering with—the relationship component. Making sure you have the right people providing your capital is a lot more important than you might think because things don't always go according to plan. When that happens you really want to have a partner who buys into your strategy and is going to be patient in working through those moments in time. That way, everybody can come out stronger in the end.