What Is Acquisition Finance?

- Acquisition financing is the funding a company uses specifically for the purpose of acquiring another company.
- By acquiring another company, a smaller company can increase the size of its operations and benefit from the economies of scale achieved through the purchase.
- Bank loans, lines of credit, and loans from private lenders are all common choices for acquisition financing.
- Other types of acquisition financing including Small Business Association (SBA) loans, debt security, and owner financing.

Types of Purchasers

- **Strategic investors**: Corporate purchasers acquire competitors ("market shares"), complementary businesses or non-related businesses (diversification).
- **Financial investors**: Collective investments (e.g., from insurance companies, pension funds, general investment funds, individuals - "family offices") pooled in private equity funds acquire companies/businesses with the aim of achieving an attractive rate of return through a sale within a limited period of time.

Sources of Funds

- **Strategic investors**: The purchase price is financed from available liquidity (or by shares in some cases) and, perhaps, from funds borrowed specifically for the acquisition, or generally.
- **Financial investors**: Private equity obtains funds from
    i. investors to invest in the shares of the target ("equity") and;
    ii. from lenders (banks, other financial institutions, institutional investors, hedge funds, mezzanine lenders) and/or investors in bonds and other capital market instruments to leverage the transaction ("leveraged finance").

Uses of Funds

The funds made available for the acquisition are used to finance:

- The purchase price paid to the seller/s.
- bank and other debt to be refinanced or repaid as a consequence of the acquisition ("change of control").
- transaction fees and expenses.

Recourse/Non-Recourse Financing

- **Strategic investors:** may obtain third-party financing for their investment in a "target company" by way of borrowings from the debt and capital markets. The resulting credit risk for lenders (normally) is that of the strategic buyer (and its entire group, including the target), irrespective of the financial performance of, and the cash flows generated by, the target company. The lenders therefore generally have **unlimited recourse** against the strategic buyer.

- **Financial investors:** leveraged finance is **non-recourse financing**.

i. <u>**Equity**</u>: Financial investors and, regularly, managers of the target company ("management buy-out") and future new managers of the target company ("management buy-in") contribute a set amount of capital (equity) to a special purpose company ("**NewCo**") that will acquire the target company. The equity is provided upfront on the basis of a business plan ("base case"); it is normally not anticipated that any further equity will need to be provided until the re-sale of the target and the repayment of the acquisition debt. The investors have <u>no obligation</u> to provide additional funds if cash requirements arise at the level of the target company in the future.

  - **Shareholder Equity:** Equity provided by shareholders (payments towards registered/stated capital, or capital reserves) is always subordinated. In an insolvency, payments to shareholders in respect of their capital participations can only be made once all other creditors have been paid off.

  - **Shareholder Loans:** Loans made available by shareholders are ranking, as a matter of principle, at the same level with all other creditors (*pari passu*). In an insolvency, however, and in some jurisdictions subject to certain further conditions, they are often subordinated to other creditors or given the same treatment/ranking as equity: "Equitable subordination".

ii. <u>**Debt**</u>: In addition to the equity paid in by the investors, NewCo will borrow funds from third-party lenders (banks, mezzanine lenders or capital markets). The debt service (repayment of funds borrowed and interest) will have to be funded from the cashflow generated by the target company. The lenders receive no security from, and have no recourse against, the investors other than security over the shares in the target company and (perhaps) NewCo. They also receive asset security from NewCo and, to the extent possible, the target group. Because there is no liability of any party outside the acquisition vehicle (NewCo) and the target group, the acquisition finance debt is <u>non-recourse debt</u>.

  - **Lender/Bank Debt:** Different lenders have equal rank, i.e., will receive the same percentage in amounts that would be recoverable in an insolvency. By way of intercreditor agreements, senior lenders agree with mezzanine and other lenders having secondary priority agree towards that the senior debt will always be satisfied first from any payments made on the acquisition debt. In restructuring scenarios it is often agreed that additional funds provided in a distressed situation is given priority over the existing debt-financing ("super senior").

  - **Debt Issuances:** Funds are provided by the issuance of capital market instruments (high-yield bonds, PIK notes).

- **Vendor Loan**: A portion of the purchase price might not be paid to the seller but be agreed to take the form of a loan that (carries interest and) is payable after, e.g., three years.

Types of Debt

Senior Debt

Senior debt is the main form of acquisition finance and will be used in all buy-outs. It will generally comprise:

- secured term loan to fund the acquisition itself (and related costs)
- working capital facility (usually a revolving credit facility)
- ancillary facility (such as an overdraft) for specific purposes

Depending on the value of the transaction, the senior debt will be provided by a single acquisition finance bank or, for a larger loan, syndicated banks. Acquisition finance may also be provided by nonbank institutional lenders.

The senior debt will usually be the largest part of the acquisition finance and will rank in priority to all other debt.

Second Lien Debt

Second lien debt is a type of secured debt which will usually rank immediately behind the first ranking senior debt and ahead of mezzanine and other junior debt.

Second lien debt has much in common with senior debt (and is often documented together with the senior debt) but it is more risky in terms of enforcement rights against the borrower than senior debt.

Mezzanine Debt

Mezzanine debt sits between senior (and second lien) debt and other junior debt. It is often secured and may also be ʻʻwarrantedʼʼ (i.e. giving the purchaser the right to subscribe for shares at a stipulated price).

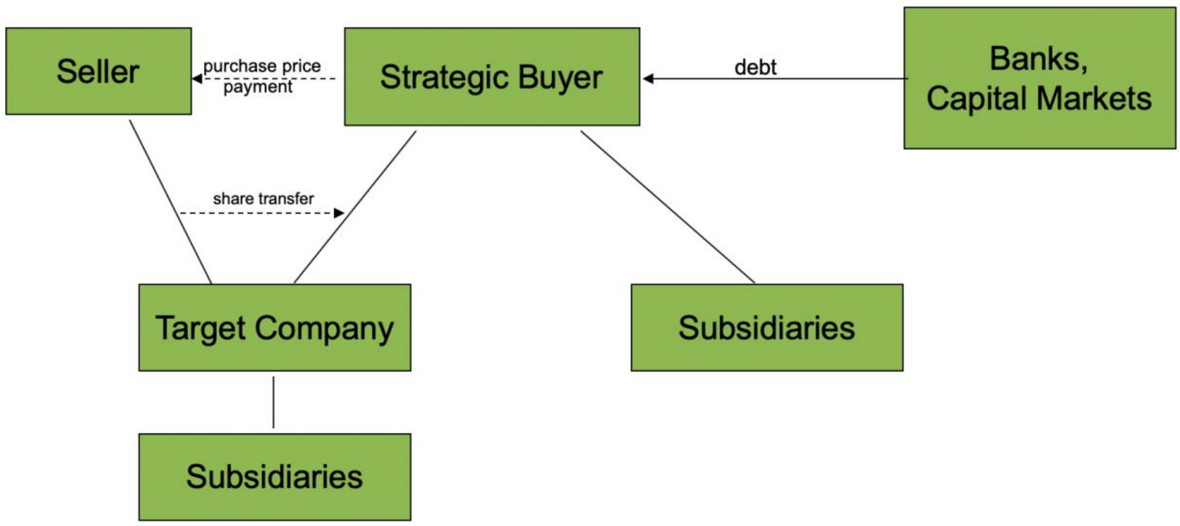
This type of debt is usually repaid by a bullet repayment and tends to be more expensive than senior debt due to deeper subordination and therefore weaker enforcement rights against the borrower.

Other Junior Debt

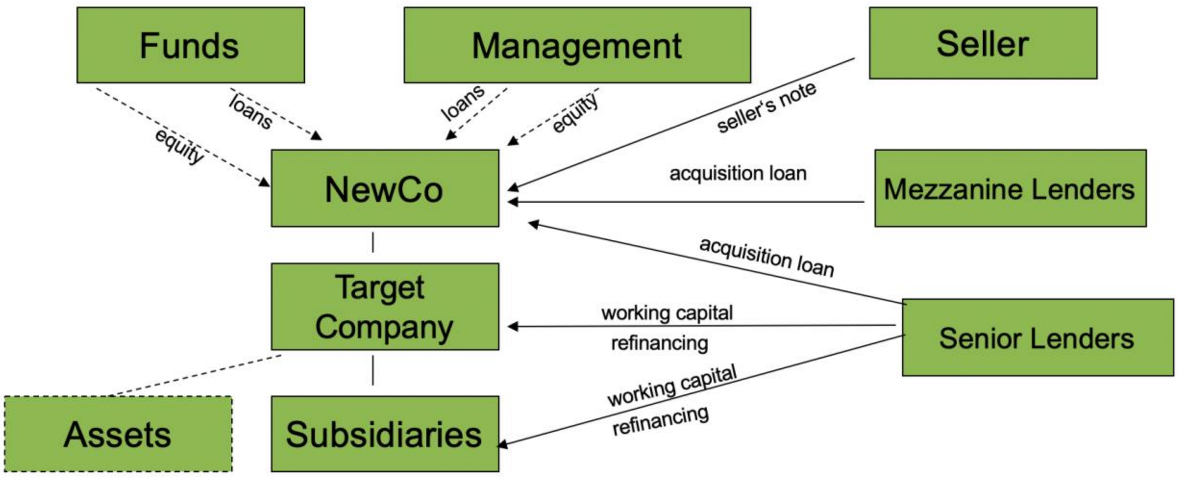
- High yield debt
- PIK note debt

Acquisition Structures

- **Strategic Acquisition**



- **Leveraged Acquisition**



Documentation of debt financing

- **Commitment Documents:** Mandate/Commitment Letter
- **Final Core Financing Documents:**
  - Senior Facilities Agreement
  - Mezzanine Facility Agreement or bond documentation
  - Agency Agreement
  - Intercreditor Agreement
  - Subordination Agreement
  - Security Trust/Agency Agreement
  - Security Agreement

- **Applicable Law/Jurisdiction**
    - Choice of Law
    - Mandatory Provisions of Local Law
- **Purpose, Term of Loan**
- **Interest, Repayment and Prepayment**
    - Interest: EURIBOR/LIBOR plus the margin plus mandatory costs
    - Prepayments: Mandatory prepayments must be made in full if events occur which change the lending structure fundamentally
- **Conditions Precedent (Conditions of Utilisation)**
    - Execution of share purchase agreement, fulfillment of all conditions precedent, transfer of ownership in shares
    - Implementation of borrowing companies' structure (NewCo, other group entities)
    - Payment of capital, shareholder loans to acquisition vehicle
    - Disbursement of mezzanine loan facilities, other subordinated debt
    - Repayment of existing loan facilities (payoff letter)
    - Confirmation that utilization is made in accordance with the purpose clause
    - Subordination of shareholder loans, other shareholder claims, vendors, mezzanine lenders
    - Execution of hedging agreements
    - Perfection of security, release of third-party security
    - Maintenance/conclusion of material agreements for target business
    - Submission of audited/unaudited annual/interim accounts, business plans
    - Submission of due diligence reports
    - Submission of tax reports
    - Submission of legal opinions
    - Legal condition: No material adverse change, no event of default (drawstop)
- **Representations and Warranties**
    - Implementation of corporate reorganization pre-acquisition
    - Legal, valid and binding obligations
    - No conflict with other obligations
    - No default
    - No cross-default
    - No proceedings pending or threatened
    - Environmental compliance
    - Tax representations
    - Due incorporation and existence of acquisition vehicle/corporate group of acquisition vehicle
    - Compliance with other relevant documents (Information Memorandum)
- **Covenants, Undertakings**
    - Information Requirements
    - Affirmative Covenants
    - Negative Covenants
    - Financial Covenants

- **Events of Default**

  - Payment default
  - Non-compliance with financial covenants
  - Cross default/financial cross default
  - Material deterioration of financial condition, inability to pay, insolvency
  - Breach of purpose clause
  - Deficiencies in security documents
  - Change of control (normally as a mandatory prepayment event)
  - Breach of subordination, intercreditor provisions
  - Breach of representations and warranties

Collateralizing Acquisition Loans

- **Assets**

  - Intellectual property (patents, trademark, utility models, design patents, copyrights, knowhow
  - Receivables, payment claims (bank accounts, trade receivables, insurance claims, financial claims, warranty)

- **Security Interests**

  - Pledge, charge, mortgage
  - Transfer of title

- **Non-asset**

  - Guarantees, indemnities, sureties
  - Negative pledge
  - Pari passu undertaking

- **Guarantor Coverage:** the structure of financing usually attempts to have the entire target group become an obligor in respect of the financing, typically be way of the target and its subsidiaries providing guarantees in favor of acquiror´s (NewCo´s) lenders.

- **Second Priority Security:** such security is extinguished when the secured obligations are discharged, and where security is automatically transferred when the secured obligations are transferred.

- **Timing:** all security must be firmly established/constituted prior to funding (first utilization) of loans.

- **Upstream Security:** Payments and other benefits made available to shareholders, and assistance provided to acquirors of shares, are subject to financial assistance restrictions or capital maintenance requirements.

- **Security Pooling Arrangements**

  - Decision-making
  - Sharing of proceeds (waterfall)
  - Responsibilities and liability of security agent

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