Financing Options When Buying or Selling a Business

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The purchase and sale of a business is a complicated and challenging process. Once a price has been agreed on, an important hurdle that buyers and sellers often face is the financing of the purchase price. This is primarily driven by the financial capacity of the buyer, and willingness of the seller to accommodate the buyers.

In general, a buyer would like to receive 100% of the cash proceeds at close. That being said, a seller could benefit from a more flexible structure by being able to attract more potential buyers and possibly obtaining a higher price. This article will explore several financial structures that can be used to bridge the gap between buyers' and sellers' pricing expectations.

Vendor takeback or preferred shares

When buyers lack sufficient capital to pay the full purchase price on closing, a vendor takeback ("VTB") may be an option to consider. A VTB can be structured several ways. Typically, payments are made over a number of years. The debt owed by a buyer to the seller is subordinated to any debt issued by the primary lender and; therefore, can be at risk if the business fails. If the seller requires access to the full purchase price upon closing, it may be prudent to obtain funding from third-party lenders instead.

While financial institutions generally have an appetite to lend to new owners of a business, a buyer must be able to contribute some equity to the transaction. This equity may come from savings, refinancing personal assets, or family contributions. Sellers should be weary of buyers who approach them with offers to acquire the business with minimal equity, a large VTB, or a VTB paid over a very long period, as these significantly increase the seller's risk.

Cash flow lending and leveraged loans

In a business transition context, qualifying cash flow lending transactions represent a unique opportunity to provide financing for acquisitions. In this case a lender will finance a portion of the acquisition price using specific parameters, mainly based on the profitability of the business. The main difference when compared with typical senior loans is that cash flow loans rely on the business' ability to deliver cash flows rather than on the collateral (or assets pledged). For example, a mortgage uses a property as collateral, whereas cash flow lending uses the business' ability to generate stable future cash flow.

As such, additional due diligence is generally required by lenders to assess this risk. Cash flow loans are frequently employed in connection with mergers and acquisitions, leveraged buyouts and balance sheet recapitalizations. These loans generally contain higher risk than other loans, as the borrowers carry high levels of debt relative to cash flow and asset values – making them more vulnerable to economic downturns, poor business performance, and rising interest rate environments.

Risks

The level of financing available will depend on the inherent risks related to the business.

The main criteria assessed by lenders are:

Stability of cash flow
Since cash flow is the primary source of servicing and repayment, lending will be based on maintainable Earnings Before Interest, Taxes, Depreciation, and Amortization ("EBITDA"). As such, lenders will assess the cash flow stability by reviewing the industry cyclicality, business seasonality, vulnerability to fluctuations in commodity prices, foreign exchange and rising interest rate environments. In addition, potential payment obligations such as earn-outs, contingencies, vendor takeback, shareholder compensation and other payout arrangements will be considered.

Enterprise value
Since there is often an asset coverage shortfall (lending value vs. fair market value of assets), leverage levels will be sized with the "Enterprise Value" in mind.

Capital structure and timeline
De-leveraging is an important factor in successful cash flow transactions. Loans generally have a five to seven-year term and, as such, the company must have the capacity to repay.

Access to alternate forms of capital
Financial flexibility and access to alternate sources of capital (e.g., equity or subordinated debt sourced from an owner's personal net worth or third-party investors/lenders) can be an important factor.

Covenants and guarantees

There are generally financial covenants required by the lenders and guarantees (personal and corporate) in the event of default. Structural features such as cash flow sweeps, limitations on debt, third-party guarantees, distributions, capital expenditures, etc., and debt service coverage covenants will be required.

Seek advice

There are several key considerations for financing a business transaction. The financing process should be given adequate attention and structured in context of the seller's willingness to finance a portion of the sale (i.e., with a VTB), the risks related to the business and its capacity to borrow and repay. A BMO Business Advisory and Transition Planning Specialist can be a trusted resource in helping you understand the financing options for buying or selling a business.

For more information, speak with your BMO financial professional.

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