The Advisor – Fall 2010

Financing Your Business Acquisition

Market conditions change frequently. There are times (like in the mid 2000's) when sellers of businesses extracted maximum value due to valuation multiples being close to all-time highs. Since the Fall of 2008 however, the market has changed in favour of company buyers. Valuation multiples have fallen in most industries. And debt continues to be relatively cheap. So how does an entrepreneur or company go about paying for a business that they wish to acquire? Here are four options to consider:

1. **Cash.** There will usually be some form of cash down payment required on any acquisition. If there is excess cash available, using some of it to acquire a business that is expected to generate greater than average returns is a good idea.

2. **Debt.** In addition to being cheap given the current low interest rate environment, debt also has the advantage of interest deductibility for tax. It could be argued that one should maximize the debt component of any acquisition given the inherent advantages to this type of financing. The risk of course is burdening the company with too much debt causing financial distress and the risk of bankruptcy.

   In order to determine how much debt can be used to finance an acquisition, a buyer should calculate how much EBITDA the target generates. Lenders look to a maximum debt to EBITDA ratio of 1 to 4 times. So if the target's EBITDA is $1 million and lenders will finance a maximum of 2.5 times, the most debt that can be used to finance an acquisition would be $2.5 million. And this assumes there isn't any existing debt on the target's balance sheet. The buyer should also determine if the target has any unencumbered assets such as equipment or real estate that can be used as collateral for a loan to finance the acquisition.

   And if the buyer is a company rather than an entrepreneur, it may have excess debt capacity on its own balance sheet that can be combined with the target's to finance an acquisition as well.

   Once the amounts above are calculated, forecasts should be prepared with the proposed debt structure to ensure all scheduled principal and interest payments can be made with relative ease. Sensitivity analyses should be performed to ensure all lender covenants are met in a worst case scenario.

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3. **Vendor Take Back ("VTB").** A vendor may be unwilling to take back a loan as part of a sale. But if third party debt financing is at its maximum and a VTB is the only way to get a deal done, they will definitely consider it.

4. **Equity.** If the buyer is a company, it can issue shares to the seller as part of the consideration. This is a great alternative in situations where the seller stays on to run the target on behalf of the buyer. It will align the seller's goals with the buyer's since everyone benefits from a higher share value.

   Private equity ("PE") can also be used to fill a financing gap after cash and debt alternatives are exhausted. PE firms will usually take a significant (but not majority) position in the company and will require Board representation.

Depending on the situation, there are numerous ways to finance an acquisition. The key is to review all of the possible options and to select the alternative that will generate the best return from an investor perspective.

Aries Advisory Group can assist you with the development of a list of alternatives to finance a business acquisition. We can present all of the options and assess their merits and shortcomings. We will then recommend which one is the best for your particular situation. And finally, we will assist you with the execution of the strategy. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.

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