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The Credit Puzzle

Deals are still getting done, but with a new focus

By Lou Banach and Jim Gettel

During the past several months, uncertainty in the commercial credit markets has led to concern about whether mergers and acquisitions transactions can be accomplished successfully in today's environment.

Synergistic deals can certainly be accomplished-with some flexibility and preparation. While successful financing of large deals depends heavily on capital markets, local middle market deals (often with a purchase price below $20 million) generally rely on a combination of commercial loans, seller financing, and equity (from private sources or a private equity group). However, in today's marketplace, the mix and nature of these financing components has changed and adaptation is required in each area of funding.

While banks and other senior lenders have become less willing to take on deal funding needs, there are still a number of options available to a creative and determined seller.

In a turbulent market, senior lenders (typically commercial banks) are willing to take on only a smaller share of deal funding needs. The multiple of cash flow (Ebitda) that many banks are willing to underwrite today is approximately 2.5 to 3 times, nearly a full turn below the multiples preferred during the last five years.

Critical to the underwriting decision remains the consistency and repeatability of cash flow to service debt comfortably. A key point to remember when dealing with bankers is that bankers use the "rear-view mirror" often: future projections are warranted, but the credit underwriting focus is on historical cash flow. Bankers regularly follow the philosophy made famous by President Ronald Reagan: "Trust, but verify."

A 1-to-1 loan-to-collateral ratio is preferred in any deal, with regular monitoring through a monthly borrowing base. As part of a buyer's diligence, a public accounting firm may prepare a due diligence report for the purpose of uncovering "skeletons in the closet" (such as customer concentrations or vendor reliance). These reports offer an objective and transparent perspective of the business, so sharing them with potential lenders builds trust and confidence in the collateral and cash flow.

"Much scrutiny by senior lenders is directed towards the buyer's credentials and familiarity with the industry."

Expect a debt service capacity test in the 1.25-times range in addition to additional indebtedness caps, primarily to ensure cash-flow adequacy. Senior lenders will require executed subordination agreements if there are junior lenders. And parent company or personal guaranties are more prevalent.

Interest rates remain well below historical averages, making this a good time to borrow prudently.

Seller financing becomes more significant

Seller paper or seller financing is a "bridge" or "middle layer" of capital between equity and senior financing. This middle "strip" (also known as mezzanine capital, and frequently provided by mezzanine lenders in larger transactions) represents the seller's ongoing confidence in the company's ability to maintain cash flow, and its commitment to assist in closing the deal. This commitment is often greater, and more necessary, as senior lenders participate less in financing transactions.

Seller financing should not be viewed as "inexpensive" money for a number of reasons. A seller who provides financing takes on substantially more credit risk than a senior lender, for which the seller must be compensated. First, the senior lender will often require a "deep subordination." This subordination may restrict a seller from receiving payments on its financing for 18 to 24 months after the deal has closed and then permit payments only under certain conditions, including no defaults under the senior lender's loan. Moreover, the subordination will usually provide the senior lender the priority position in collateral. A buyer must expect to compensate the higher risk to the seller through a higher interest rate or purchase price.

Given the dearth of investment vehicles producing decent returns today, seller financing may be a good investment for a seller if a proper balance between risk and return is reached. A seller may be interested in helping to facilitate the transaction, but also must be willing to forgo the opportunity to otherwise invest the proceeds.

Like seller financing, equity investment is important to make up the portion of the purchase price that senior lenders are no longer funding. Moreover, it is needed to build the confidence of senior lenders and sellers in the foundations of the business. Lenders to the business will also especially consider the remaining "untapped" reserves the buyer will have available after the transaction should the company need a cash infusion-whether there is an adequate cash-flow "cushion"-in these volatile econom-

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between the various provinces and regions in China. It may not be necessary or possible to fully understand all the differences between the cultures within China. However, it is particularly important to develop appropriate relationships with business partners that are knowledgeable of the local culture, government relations at all levels, and legal and regulatory compliance. Americans often mistakenly identify a business partner because they are from China and they are very presentable with excellent Mandarin and English skills, but the Chinese business partner may have very little knowledge about the local business environment of the target company or they may not have adequate business or negotiation experience.

Perhaps the most overwhelming challenge that a US company will face in China is negotiating the deal. Prior to making an attempt at negotiating a transaction, it is imperative to understand the Chinese negotiation approach. Western companies should be prepared to spend significant time courting the Chinese target and should expect to attend several very long meetings. To many Americans, it may appear that nothing is getting done and these meetings may not be perceived as necessary. But, if the proposed transaction seems to be a favorable deal, the additional time spent is warranted and essential in forging long-term relationships. In addition, once a contract is signed, the US party may believe there is actually an agreement in place and the deal is done. Nothing is agreed until everything is agreed and a common surprise to Americans is that often after an agreement is signed, the Chinese party will want to continue negotiating the deal. This should be expected, whereas nothing is unusual in China.

"Management may not allow access to financial and non-financial information until several meetings have been conducted."

In summary, US companies that plan to invest in China must be prepared to go the distance and anticipate delays and setbacks. However, a successful Chinese deal is possible and the cultural differences, language barriers, and unfamiliarity with local business laws and practices can be overcome with extreme patience and an appropriate approach to the transaction.

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ic times. Cash is king, and buyers with cash available are in a great position to get deals done.

While it is certainly true that more equity helps in getting the senior lender and seller on board, who it is from matters as well. Much scrutiny by senior lenders is directed towards the buyer's credentials and familiarity with the industry. This will make experienced private equity buyers or strategic buyers with significant synergies especially favorable to senior lenders. Many private equity groups have money to invest and are looking for deals; this seems to keep them in the market, even though their investment returns are lessened by the reduced leverage (share) of senior debt.

"Financing structures are adapting, with a greater emphasis on seller financing and equity. Limitations on acquisition funding are not so much onerous as prudent."

Even in these uncertain economic times, with the right planning and focus, deals are getting done and capital is available for middle market deals in the Midwest. Financing structures are adapting, with a greater emphasis on seller financing and equity. Limitations on acquisition funding are not so much onerous as prudent. It will be important for both buyers and sellers to work with M&A advisors who understand how to make these structures work for the business and transaction, and who can find and maintain excellent relationships with the best sources of funding. It continues to make good business sense to pursue and accomplish strategic acquisitions and sales whenever synergies will create additional growth and value.

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vestment, sound management expertise and the economies of scale realized through a prudent acquisition, investors can develop a successful and profitable oil field service business in the Canadian market. Companies created with a tactical consolidation plan will create a strong competitor that can gain significant market share within the Canada's profitable oil fields.

As Shell and other top tier producers increase their stake in Canadian tar sands, prospects for long-term high yield investment will continue to grow - particularly in oil field service, technology and infrastructure companies. For American private equity investors seeking profitable middle market business opportunities in the energy industry, look north of the border. Today, Canada is the land of opportunity.

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