CEREBRO CAPITAL

ACQUISITION FINANCING

LOAN GUIDE

Tips to prepare for financing a business acquisition

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Acquisitions are a key aspect of business. They allow companies to grow, introduce new ownership, and even diversify into other business segments. While there are many reasons why you might consider an acquisition, you will almost certainly have to fund your acquisition with a combination of cash and financing. Acquisition financing is useful in helping to carry out an acquisition in a timely manner without having to break the bank with upfront acquisition costs.

This comprehensive overview will guide you in the process of acquisition financing from start to finish.

What is acquisition financing?
Most businesses don't have enough cash on hand to make an acquisition outright. Acquisition financing is used to obtain capital for the sole purpose of acquiring another business. Since no two acquisitions are alike, the financing process requires thorough planning and preparation, and lenders are quite meticulous about gathering all applicable information before agreeing to deal terms.

TOP FAQS ABOUT ACQUISITION FINANCING

1. **Can seller financing cover the cash equity requirements from lenders?**

Lenders typically require 10%-30% in cash equity from the buyer, regardless of any seller financing agreements. Lenders expect that buyers are committed to the target company as demonstrated by a cash injection and not just a seller note.

2. **What interest rate can I expect to receive for acquisition financing?**

Loan terms vary based on the type of lender and loan size. Commercial banks will offer the lowest interest rates but only companies with sufficient collateral and size will qualify for low single digit interest rates. The most important question regarding interest rate will be how much can the company afford to pay and still generate a profit. This calculation is considered the debt service coverage ratio.

3. **How do lenders underwrite acquisition financing loans?**

Lender underwriting requirements for acquisition loans may vary from lender to lender, but typically lenders will analyze the experience level of new buyers in that particular industry or business model and the strength of the target business including historical financial performance and future outlook.

4. **How long does it take to close an acquisition loan?**

Keep in mind, buyers will likely only want to engage lenders after they have finalized an LOI with the seller. This ensures the buyer and lenders are not wasting their time on a deal where the two parties aren't in agreement. Once a complete loan package is ready to present to lenders, buyers can expect the process to take anywhere from 2 to 4 months to closing. The variance will largely depend on the quality of the financial information the seller provides and if the lenders will need any third party valuations such as quality of earnings (QofE) or appraisals.

TYPES OF ACQUISITION FINANCING

SBA 7a Loan

- Loan Size: $5MM max
- Collateral: Business assets are pledge and Personal Guarantee is required
- Cash Down: Min. 5-10% of total acquisition price depending on industry but lenders may ask for more
- Terms: 6% interest, up to 10 years
- Loan sizes, cash requirements and lender appetite will vary from lender to lender

Loan from Non-Banks

- Loan Size: 4-5x EBITDA depending on industry
- Collateral: Pledge business assets but no personal recourse/guarantee in most cases
- Private Debt Funds, SBICs, BDCs, etc
- More flexible structures and covenant light agreement but interest rates are higher and some might want warrants or equity

Conventional Bank Loan

- Loan Size: 1-3x EBITDA
- Cash Down payment: Typically require around 20% or more depending on company size
- Collateral: Seeks 100% collateral support or will seek personal guarantee to cover the deficit
- Available for companies with material tangible assets, cash flow $5MM+, or strong personal balance sheet within ownership group
- More stringent in their approval process, but if approved, provides lowest cost loan terms

Equity Investment

In some cases, debt financing is not an option for the acquisitions and so buyers provide cash and/or stock in return for ownership. This is true for early stage companies who have little to no historical performance. In many cases, equity investment is used in combination with acquisitions financing to meet the full asking price of the seller.

For example, a buyer might seek $15 million in debt and $5 million additional equity from investors to secure $20 million for an acquisition.

COMMON MISCONCEPTIONS

If the seller is offering a note or equity roll, I can finance the remainder of the purchase price with debt.

Regardless of any deal between the buyer and seller directly, typically lenders will require 10-30% in cash equity from the buyer. This ensures the lender that the buyer has skin in the game and is fully committed to getting a deal done. Unfortunately, seller notes do not count toward this cash payment.

Company prepared financials will be enough for a potential lender.

Lenders don’t trust company prepared financials as much as audited statements, and therefore, this won’t be enough information for you to receive financing. Lenders will first verify the information provided with tax returns. If the financials provided do not match tax returns, a Quality of Earnings report will be requested. For larger acquisitions above $5 million, a Quality of Earnings report will likely be required regardless.

If the seller wants to move quickly, I must close the loan within 30-days.

Most multi-million-dollar loans take between 2-4 months to close. This is, of course, dependent on the type of lender, size of the company, and loan size, among other things. If you attempt to rush into this process you could be red-flagged, and seen as trying to hide something from your lender. Don’t expect lenders to rush through their due diligence process. The only thing you can do to close a loan more quickly is to be fully prepared and immediately respond to your lender’s requests. Buyers should be wary of sellers that have unreasonable expectations on loan closing timelines.

COMMON MISCONCEPTIONS

I won't have to pay any money until the financing process is done and the acquisition is complete.

You might not want to pay any money until you know with absolute certainty that the acquisition will go through. Unfortunately, at certain points throughout the process the buyer will have expenses in order to keep the process moving forward and to indicate their sincere interest. One of the biggest fees buyers will pay along the way is to its advisors. Advisors like accountants and lawyers are useful in helping you put together the necessary financial statements and paperwork to complete your financing. You will need their help throughout the acquisition process, and will pay for their time regardless of whether or not the deal goes through.

To reduce the risk of a deal falling through, you can request the seller sign an exclusive LOI with an option to extend the time to close if the lender needs more time to conduct their diligence.

As a buyer you can also choose to put down a small percentage of the sale price as a deposit, an act that while not necessary, proves to the seller that you are working in good faith.

ACQUISITION TYPES

There are a variety of reasons a business might be interested in undergoing an acquisition. These range from growing an already existing business, to minority partners looking to buy-out management. If debt is used to acquire the business, many will refer to it as a Leveraged Buy Out or LBO. Here are the different types of acquisitions and why they are used.

Add-on Acquisitions

An add-on acquisition occurs when one business purchases another to build on top of their already existing operation, thus bringing on the acquired company into the acquiring business.

This may include purchasing a supplier, competing business, or complimentary business that would add value to your already existing business. Or, you might seek an add-on acquisition as part of a larger roll up strategy, where many small companies in an industry are acquired and merged together into one larger company.

Important Considerations

Because both businesses in an add-on acquisition will come together as one, the historical performance of both entities are important in financing the deal, along with the pro forma financials of both entities combined. Lenders want to see that the businesses will not only mesh well together, but that the acquisition has a high likelihood of growing revenue and profits of both businesses when merged.

ACQUISITION TYPES

Stand-alone Acquisitions

In a stand-alone acquisition the acquiring party takes control of another company, but allows its target acquisition to continue operating as a separate business.

This is the most common acquisition type utilized by private-equity firms, independent sponsors and individuals seeking to become the owner/operator of a target business. Generally, the acquiring party believes it has found a business that is operating at sub-par efficiency and profitability, and believes with new management and changes to its operations, the business can increase its value.

Important Considerations
In this type of acquisition, the target firm's financial performance will need to support the **entire loan request** on its own since it will remain a stand-alone business and its operations will not be absorbed into an acquiring business. Lenders for stand-alone acquisitions will want to see that the acquiring party has management experience in the target's industry or business so that it can better ensure success after ownership changes hands.

ACQUISITION TYPES

Management Buyout (MBO)

In a management buyout, the company's management team seeks to buy the company from its owners.

In this process, the management team moves from employees to owners — or as minority owners to majority owners — as it takes control of the company.

Important Considerations
This type of acquisition can be more favorable to financing terms as the management team has proven experience with the company, and is less likely to disrupt its operations in the transfer of power.

MBOs may also reduce the risk to the owner of confidential information being disclosed during the sales process.

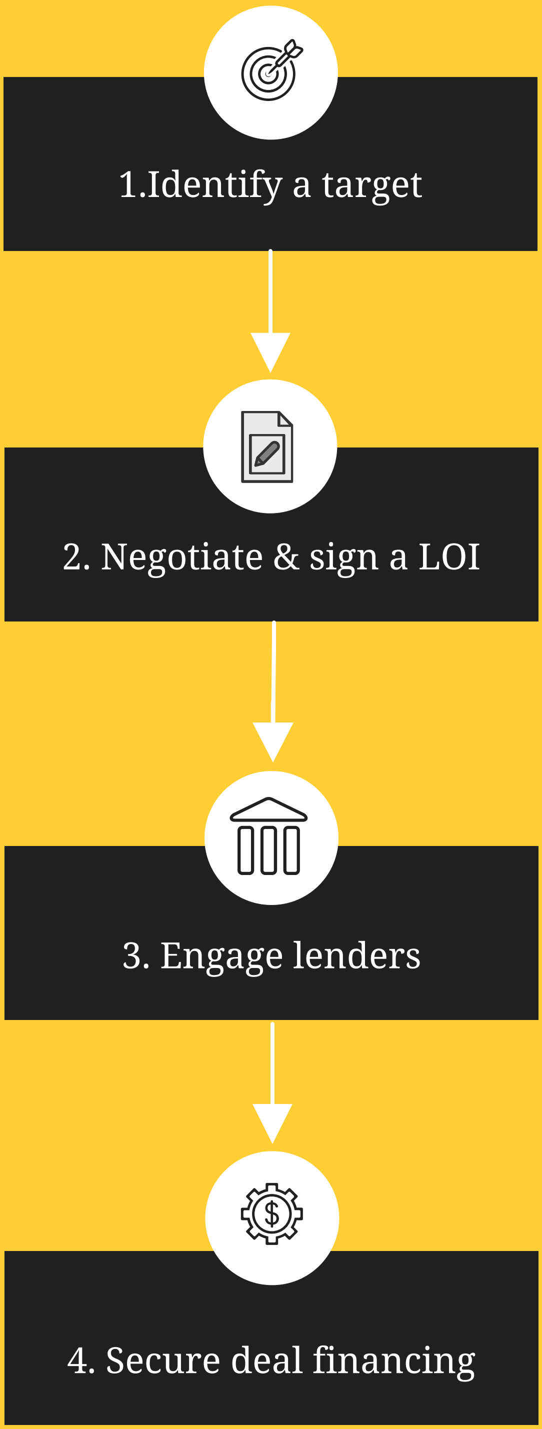
Partner Buyout

In a partner buyout, one or more partners in a firm seek to buyout an existing partner.

Because both parties have worked closely together oftentimes for years or decades, this can be an emotional process with contentious negotiations. If partners disagree with one another as to the value of the company, a buyout agreement may be hard to reach. However, if a partner wants to leave to focus on family or other projects, a partner buyout can also be an amicable way for the retiring partner to cash out.

Important Considerations
Identify any critical terms for the buyout before you seek financing to ensure that you are matched with the right lenders that can support you.

STEPS TO SECURE ACQUISITION FINANCING



1. Identify an acquisition target

Financing can’t be obtained based on a general type of target you considering. Instead, a specific target company is necessary before receiving lender proposals.
While lenders may be willing to provide a general overview of acquisition financing requirements, they won't provide detailed term sheets without an understanding of the target company financials.

2. Negotiate & sign an LOI

Your letter of intent (LOI) should include the proposed price and high level terms for the acquisition including what assets are or are not included in the sale and how much the seller might be willing to finance. Its in the buyer's best interest to negotiate an exclusive LOI so the seller cannot pursue other buyers during a specific time period. A seasoned attorney with experience in facilitating M&A deals can help drafting LOI language.

3. Engage lenders

With a signed, exclusive LOI and access to the target's financial package, you are now ready to complete a detailed loan application and engage lenders.

The first step will be to compile a loan package which includes all relevant documents and materials on the buyer and the seller. Ensuring you have an open dialogue with the sellers, will ensure you can turn around information to lenders on a timely basis.

The type of loan, interest rates and structure of the loan will vary greatly between lenders. It's important to ensure that your profile deal aligns with the lenders loan types and that you are engaging enough lenders to create competitive tension.

It might take anywhere from a few days to a few weeks to receive a written term sheet, but it will ultimately indicate to the seller your ability to finance the transaction and the seriousness of your offer.

Documents to include in your loan package:

- Signed LOI between buyer & seller
- Company overview
- Biographies of buyers & any remaining management team members
- Historical financial reports - IS, BS & CF (3 years)
- AP & AR aging reports
- Tax returns - 3 years
- Asset details (if applicable: equipment list, real estate appraisals, etc)

Note: If executing an Add-On Acquisition, these same files will be needed for the existing business as well as the target business.

4. Secure deal financing

Receive & evaluate lender term sheets

At this stage, you have requested financing from one or more lenders and will begin to receive financing offers. Each term sheet may vary and likely will carry advantages and disadvantages. Important terms to consider:

- Typically the lower the interest rate the less flexible the other terms will be
- Prepayment penalties should be considered if buyer intends to refinance soon or the business has the potential to pay off the loan within 1-2 years
- Is the loan size big enough to support the acquisition price and additional working capital needs once the new owners take over
- Does the lender require you to maintain a depository relationship at their institution (most relevant for commercial banks)

Pick your lender

Once you select a winning lender, you'll be asked to sign a term sheet stating the agreed upon financing terms. Upon signing this document, you will be asked to put down a deposit.

Cerebro Capital can help you engage multiple types of lenders simultaneously in a matter of days. Get lenders to bid on your business by starting a process with Cerebro today.

Click here to schedule a call with a loan consultant.

STEPS TO SECURE FINANCING

Diligence & Closing

After a term sheet is signed, the lender will complete a more in depth diligence process in order to receive final approval from the credit committee to fund the loan.

If the company does not have audited financials, the lender may require a third party validation such as a Quality of Earnings report (QofE), though this will depend on the lender and size of the transaction. For acquisitions involving tangible assets, lenders may also require a new appraisal.

Closing can be delayed because of issues with the due diligence process, but closing should not generally take longer than 4-weeks. After the loan is fully funded and funds change hands, the acquired business transfers its ownership to the buyer, thus completing the entire acquisition process.

Loan acquisition costs that might be required prior to close:

- Quality of Earnings (QofE)
- Appraisals
- Field Exams
- Legal Fees
- Lender deposit

Post-close acquisition strategy

Now that the acquisition and transfer of ownership is complete, it's time to follow-through with your acquisition strategy. Consider how the new buyers will train and transition leadership. Also, consider how systems and reporting will be impacted by new management.

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WHY CEREBRO?

The acquisition financing process can be lengthy and time consuming for a buyer. Every buyer wants the best financing terms possible, but they often don't have the time to speak with lenders individually and negotiate through the complexities of this process. Concurrently, middle market borrowers don't have the resources or real-time data at their disposal to put them in the driver's seat for the acquisition lending process.

Cerebro Capital combines decades of industry experience with the latest in financing technology Cerebro's commercial loan software is an all-in-one platform that streamlines the loan sourcing and management process allowing buyers to access broad and diverse group of lenders.

Benefits include:

- Access to 800+ lenders
- Data-driven lender matching process
- Expert capital markets team

Cerebro will help you with the entire process including loan application, lender identification, diligence and deal close.

Get started today by completing a loan assessment.