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Business Sellers Increasingly Play Banker

Creative financing can help sellers command better prices or close deals. It can also create complications among banks, sellers, and buyers

By Monica Mehta

During the recession, merger and acquisition activity in the lower-middle market (private companies with up to $100 million in annual sales) was anything but active. Now sharp discounts of private company valuations—I'm seeing 30 percent to 40 percent reductions from 2007 levels—are again piquing buyer interest. But with deals on the table and the dialing for dollars begun, the bank loan market, which is still licking its wounds from the credit crunch, is coming up short. Buyers are increasingly turning to sellers to fill the funding gap. It's not that financing is unavailable. Companies with strong recurring cash flow and significant collateral can still obtain debt. They're just raising less of it and at a higher cost.

Acquirers accustomed to providing only 30 percent equity and funding 70 percent of a deal through bank loans are now lucky to get a commitment for even 50 percent of the purchase price. Increasingly, they are looking to the seller to supply a separate loan (often called a note), to cover the remaining 20 percent. The seller is becoming the lender of last resort.

Seller participation in deal financing is not new. Most prerecession deals included some kind of earnout provision that delayed payment of a portion of the purchase price—up to 20 percent for one to three years. Despite cutting down the immediate tab for the seller, earnouts continue to be used primarily as insurance against seller misrepresentations post-closing.

In most instances, a seller note is still issued on top of bank debt and earnouts. When any portion of a purchase is financed by a conventional lender, seller paper is almost always subordinate in terms of when the note is paid and the ability to exercise remedies in the event of a default. Transactions are highly negotiated, with terms varying widely from deal to deal. Seller paper is usually held longer than a bank loan and can have limited transferability. Commensurate with the additional risk, interest rates for seller paper are almost always higher than those for traditional loans.

A SEAT ON THE BOARD?

When much of the purchase price is tied up in notes and earnouts, it's not uncommon for the seller to remain involved with a company for three to five years post-closing. Unlike a clean sale with residual involvement, the seller's realization of the purchase price is now tied to the buyer's ability to operate the company profitably. Bear in mind that seller paper is unsecured, with limited transferability. When a deal goes south it can get messy fast. As the junior lender, the seller will take a back seat to the bank (the senior lender) and will not have many remedies.

As a result, the seller has greater incentive to monitor the new owners and how they spend cash. This may involve seeking a board seat so as to have a say in critical business decisionmaking, including key management changes, new fundraising attempts, and large capital expenditures. It's fair to say that neither the buyer nor the seller may relish

such continued participation.

To avoid conflict down the road, it's best to keep paperwork in order, document the specific terms of a seller note in a separate credit agreement, and attach those terms to the purchase agreement. Prepare for a senior lender that may also require an intercredit document to memorialize the terms and rights provided to the junior lender. Like a bank, the seller must evaluate the buyer's credit and consider carefully the buyer's ability to repay the loan. With higher bank loan margins and Libor floors, today's funding costs are 5 percent to 7 percent higher than the terms of an equivalent loan just three years ago. Fortunately, the seller is in the right shoes to make the call as to whether the buyer can manage the increased costs. After all, few will know the business better.

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