Strategies for Growth Amidst Challenging Times:

The Return of the Stock Deal and Other Clever Tools for Funding M&A Growth in Today's Market

By Benjamin Gordon and Karen Rutt

Did you know that GE (General Electric Co.) was established by Thomas Edison when he developed the incandescent light bulb during the Panic of 1873? With cash scarce and the market in decline, it might seem counterintuitive to vigorously pursue growth. However, great companies, like GE, have shown tremendous gains during challenging market conditions because their founders used inventive strategies to pursue the opportunity. In today's environment, smart supply chain owners are similarly using inventive financial tools to execute aggressive M&A growth.

As the CEO of a supply chain operation, what adaptive strategies can you use to ensure your business expands and prospers? Despite the lack of financing available in the current market, supply chain owners continue to pursue winning M&A strategies through the use of creative structures less reliant on cash. BGSA has helped clients deploy these structures throughout the past year, and anticipates an increase in such strategies in the coming year as well. All-stock and other types of non-cash consideration are increasing in frequency as companies seek other methods for closing transactions. In this article, we will share some tools that supply chain executives are using for pursuing M&A expansion in a cash-constrained market.

Return of the Stock Deal

The most straightforward non-cash structure is the stock deal. In a stock deal, an acquirer pays for equity of the target company by using stock in the newly combined company. This model was the historical norm. From 1900 to 1985, over 50% of corporate mergers were stock-only agreements. However, from 1986 to 2007, when financing was cheaper and more readily available due to relaxed lending and new debt innovations such as the junk bond model, all-stock mergers plummeted to less than 10% of all deals. The last 12 months have seen a regression to historical norms, as all-stock mergers rose to over 25% of all transactions. Over the coming year, we expect to see this percentage grow.

Stock deals make sense in today's economy, as cash is scarce and M&A financing is difficult to access. Stock transactions can eliminate the need for financial sponsorship and reduce the hard cost of capital.

In addition, some sellers are reluctant to pursue intelligent strategies due to their concern about current valuation. Stock deals can eliminate this concern. Amidst uncertain valuations, a stock transaction combines two companies, and the only relevant issue is relative valuation, not absolute valuation. In other words, if two companies are combined, it doesn't matter whether the seller's valuation is high or low; all that matters is the valuation in proportion to that of the buyer. If one company has $20 million of EBITDA and another company has $10 million of EBITDA, the companies have proportional amounts of debt, and the businesses combine on a stock basis, then the buyer owns 67% of the equity, while the seller owns 33% of the equity. This structure enjoys the clear benefit of simplicity.

Smart sellers also like stock deals because of tax benefits; if structured properly, they can often avoid or defer capital gains taxes.

Earn-outs: Get a Piece of the Pie

A second creative acquisition structure that minimizes the need for cash financing is also increasingly viable today: the earn-out. An earn-out enables a portion of the transaction value to be deferred over time, typically based on the company's future performance. An example of an earn-out is the profit sharing model, whereby the seller keeps a portion of any profit beyond a target amount for an established time period. This arrangement can be favorable to buyers and sellers, because it eliminates buyer risk and aligns both parties with the company's best interests and ongoing performance. It also decreases upfront tender requirements for the buyer and allows the seller to potentially earn greater returns over time.

A recent example is instructive. BGSA was consulted by the founder of a private company who wished to sell but was willing to remain with the company for a multi-year period thereafter. After discussions with a prospective partner, the seller anticipated significant advancements for the combined company post-deal, due to combined strengths in expanded services and customers. Consequently, the seller agreed to an earn-out structure. The founder accepted a smaller upfront payment, eliminating the buyer's need for outside financing. In return, the seller was able to negotiate a multiple of the profit generated above the established target. In the year following the transaction, the combined company cut costs, cross-sold services to existing customers, and entered new markets. With the combination of upfront dollars and earn-outs from the value created, the seller received an above-average valuation for his business. Meanwhile, the buyer also benefited, as it gained a motivated partner who continued to grow the company and create value post-deal.

Cash is King

Alternatively, in cases where cash is preferred but expensive to access, executives may consider a seller financing or equity financing covenant. When a seller doesn't have an immediate cash need, and when credit is prohibitively expensive, a seller financing arrangement may be ideal for both sides. In a seller financing model, a seller can offer a debt note to the buyer to cover part or the entire transaction price. In an equity financing covenant, a company can sell shares of its stock to cover the cost of an initiative. This can result in a true win-win, as the buyer can gain financing on terms that are more favorable than those provided by a bank, and the seller can gain a stream of payments that is often superior to its alternatives as an individual investor in the debt markets.

Keep the Strategy

The bottom line is that while financial markets remain choppy, smart executives are executing aggressive blueprints for growth, but with innovative deal architecture. Arrangements that include all-stock, earn-out or seller financing constructions can resolve limited credit availability, high costs of capital, and unpredictable performance expectations. As a supply chain business owner, don't drop your growth strategy because of the economy. Instead, adapt your tools and stay true to your expansion plans. Companies that employ creativity and ingenuity amidst the current challenges, like GE in 1873, will be well-positioned for long-term success.

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