HERE'S THE DEAL: M&A INSIGHTS

'Til Debt Do Us Part...

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As described in previous publications, M&A transactions are traditionally structured on a cash-free and debt-free basis. In the traditional sense, debt includes amounts owed to banks or other third-party lenders and is repaid over a set period of time at an interest rate dictated in the debt agreements. However, in the context of a deal, the definition of debt can mean so much more. Audited financial statements generally include both short-term and long-term debts owed with specific terms and future payment schedules summarized within the notes to the financials. At face value, this level of information may appear to suffice for inclusion in purchase documents as amounts to be settled by the seller; however, a deeper dive is generally needed to ensure both a seller or buyer are aware of other items that can be considered debt-like in nature. While the concept of debt-like items can be subjective, a holistic view of a company's debt inclusive of such items must be navigated to successfully close a transaction and safeguard both parties from unwanted surprises post-closing. This article will cover the basics of net debt, provide insight on certain items that are traditionally negotiated as debt-like in a deal process and provide suggestions on how to best address these items in the context of a transaction.

Defining Net Debt

The term "net debt" is used to specify a company's cumulative traditional debt balance including bank debt, third party debt, amounts drawn on existing lines of credit and any accrued interest, less cash and cash equivalents on hand at a point in time. Net debt generally represents a dollar-for-dollar reduction against the purchase price, so understanding what is included in the definition of debt within the purchase documents is imperative as it has a direct impact on the proceeds that transfer at the time of close. Cash and cash equivalents are normally included as a reduction against the total debt balance because the seller traditionally has rights to these assets and the expectation is that this cash will be used to pay down outstanding debts at time of sale. As part of the due diligence process, transaction accountants will gain an understanding of the daily needs of a business and analyze many aspects of a company's balance sheet, including the underlying transaction level details of significant general ledger accounts to uncover additional items that should be considered for inclusion with net debt.

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Capital Lease Treatment

Capital lease liabilities are recorded on the balance sheet and signify total future lease payments owed to a lender for the use of certain assets a company has to support operations. These lease liabilities are considered debt-like in nature because the company is required to make monthly payments to the lender over the lease term for assets that are expected to convey or transfer in a deal and are not free and clear. A buyer and seller should understand capital lease agreements and determine if it is appropriate for the seller to pay-off the remainder of the lease payments as part of the transaction, or if the buyer will assume the leases as part of the transaction.

Debating Unearned Revenue

Unearned revenue represents earnings to be recognized at a future point in time once certain service obligations or performance metrics have been met, and in most cases occurs when payment is received by the company prior to performance of such services. As such, these service obligations may transfer to a buyer in a deal. Remember, unearned revenue is traditionally revalued in purchase accounting so the obligation on the balance sheet today may not be indicative of the liability a buyer is inheriting. A buyer and seller should agree upon the treatment for unearned revenue to determine the amount of revenue a buyer should expect to assume upon closing a transaction and whether any cash should be left in the business to cover the cost of fulfilling the service obligation.

Affiliated and Related Party Items

The structure of a company is important to consider when determining the existence of debt-like items. A company that is consolidated with subsidiaries or affiliates for financial reporting purposes but is expected to be carved-out as part of a transaction may give rise to intercompany or related party payables. For example, an affiliate of the company may make payment for certain expenses on behalf of the company. In this instance, the company will typically record the expense, but instead of paying with cash, a related party payable balance will be recorded to the balance sheet. Secondly, ownership or affiliates of a company may sometimes provide loans to that company to fund operations or purchase fixed assets, rather than obtain such funding from external parties. In such cases, these related party notes are segregated from typical third-party notes and included on the balance sheet as such. In either case, buyers and sellers should be aware of all intercompany, affiliate and related party transactions that have been made with the company, as any outstanding balances owed are generally considered debt-like items and the responsibility of the seller to pay off prior to closing a transaction.

Capturing Transaction Expenses

Both a buyer and seller incur expenses from various advisors including lawyers, investment bankers and accountants, among others, throughout the course of a transaction. Each side typically is responsible for covering their own costs, but a buyer needs to be particularly aware of how the seller is tracking and recording these expenses to their general ledger at time of closing the transaction so that none of these obligations fly under the radar and transfer to a buyer. Any bills received by the seller for transaction related work but have either gone unpaid and are sitting in accounts payable, or may not yet be recorded, need to be tallied and included as debt-like items.

Pro-Forma Considerations

Pro-Forma considerations are typically contemplated during a transaction and often included in the quality of earnings analysis to capture the potential upside to EBITDA that a company may experience. Generally, these considerations often involve cash outlay, such as additional capital expenditures, to generate the expected benefit to earnings. For example, a restaurant franchise may be required by the franchisor to make upgrades to machinery, signage or layout of their stores, with the expectation of a return on investment through cost efficiencies or increase in customers.

While the seller may have paid for a portion of these upgrades, further costs may still be needed to finish the upgrades in the future after a transaction is expected to close. In this instance, the remaining cost of required upgrades can be viewed as debt-like in nature, due to the fact these expenditures are at a minimum needed for normal course operations, but even more so, should be the responsibility of the seller to achieve the EBITDA upside being presented by the seller.

Impact of Change in Control Provisions

Depending on the industry, contract agreements with both customers or vendors may play a key role in the financial performance of a company. If a change in ownership occurs, certain clauses in an agreement known as change in control provisions may be triggered. As such, this leaves open the possibility that run rate revenues and expenses may differ from what has been presented during the deal process. Some examples of this could be the potential loss of a customer or a change in pricing structure from certain vendors. If it is determined that a change in control would lead to potential increase in costs or decrease in revenues to a buyer, the loss in value can be aggregated and treated as debt-like in nature.

Company and Compensation Policies

Certain policies of a company may cause an impact on company earnings in a post-closing environment. For example, employee benefits such as bonuses or commissions earned, expected severance for work force reductions and accrued but unpaid vacation hours, among others, may have been incurred by the seller prior to the close of a transaction, but not recorded to the general ledger or made known to the buyer. Additionally, if the company is self-insured, potential exposure exists for cost of outstanding medical expenses incurred by employees but not paid or reported at the time a transaction is closed. Because human resource policies and employee benefits generally change in a post-transaction environment, the buyer and seller should be aware of all such liabilities and determine which amounts should be considered debt-like in nature, with the potential payout the responsibility of the seller.

Litigation and Taxes

In addition to employee related expenses, litigation or other regulatory liabilities that are known or estimable at the time of transaction closure should be considered debt-like in nature as these potential expenses are the responsibility of the seller to cover. In many instances, potential costs of litigation or outcome may not be known at the time of transaction closing, thus necessitating clauses in the purchase agreement to ensure a buyer is protected. Outside of litigation, pre-closing income tax expenses should be considered as well. While known income tax liabilities are generally paid by the seller, certain balances may not be tracked properly or recorded within a company's books. In particular, tax nexus has become an important topic in recent years, due to the growth of internet sales, thus a buyer and seller should keep in mind the potential impact from unaccrued and unpaid state sales taxes.

Net-Debt and the Purchase Agreement

Now that we have run through examples of certain debt and debt-like items to be aware of as part of a transaction, it is important to know how to properly address these items in the purchase agreement. First, the buyer and seller should identify each item considered to be debt or debt-like, and who is ultimately responsible for covering the cost of these items. The definition of debt in a purchase agreement traditionally includes liabilities such as outstanding bank obligations, capital leases, etc.

As it relates to debt-like items, certain balances that are known or estimable at the time a transaction closes, and for which it is determined that the seller is responsible, can be settled by the seller at this time. Issues may arise for certain debt-like items that are not-estimable, change value or were unknown at the time a purchase agreement is completed. For these reasons, it is generally preferable to include representations and warranties as well as appropriate disclosures within the purchase documents that give the buyer the ability to claw-back proceeds from the purchase, a portion of which are generally held in escrow for an agreed-upon survival period. In addition, the seller and buyer may decide that a basket clause may be needed to safeguard either side from unwanted losses post-transaction. With the work of a transaction accountant to help uncover debt and debt-like items, both a buyer and seller should be further armed with the knowledge needed to close their deal successfully and make sure both sides are content with the outcome.

Spencer Rees is a Senior Associate in our Transaction Advisory Practice. Spencer helps strategic acquirers, ranging from private organizations to publicly traded companies, perform financial due diligence for various investment opportunities. He also supports financial sponsors, including private equity firms, mezzanine funds, family offices, and minority investors with broader transaction assistance in both buy-side and sell-side engagements. Within transaction advisory, Spencer focuses on quality of earnings, net working capital, and net debt analyses.

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