Irish Examiner

A Special Report

# Corporate Finance

September 30th, 2022

## How can businesses navigate choppy economic waters?

# Businesses struggle to access working capital

Companies often look to expensive 'quick fixes' to meet working capital requirements which may not be suitable for their requirements, writes **Jillian Godsil**

Finance is the lifeblood of every business, whether it is short-term working capital requirements or longer-term bond issues to fund business growth, every company needs access to finance if it is to succeed.

In the immediate short term or working capital requirements, businesses are coming up against a combination of inflation, economic uncertainty, exchange-rate volatility and supply-chain disruption, which is leading to concerns. For example, because of continued disruption in supply chains and shortages of some materials, more and more businesses are changing from a 'just-in-time' to a 'just-in-case' approach to purchasing, resulting in a stockpiling effect. This investment in additional inventory is leading to additional working capital requirements which may need to be funded by borrowings.

Damien Hunt is working capital lead for PwC Corporate Finance. He knows that businesses have an absolute need to invest in the growth of their business and cannot do so without adequate levels of working capital being available.

"Entry into new markets or availing of growth opportunities can only be achieved with the availability of working capital. However, growth should always be at a manageable and sustainable level to avoid an overtrading scenario," he says.

"Interest rates are increasing, and additional working capital will come at a higher cost. Banks and finance providers are also becoming more selective in extending credit. Often businesses look to expensive "quick fixes" to meet working capital requirements, which may not be suitable to each individual business's profile. Better management of payables, receivables and inventory will result in the release of cash which can then be utilised to fund additional working capital requirements without any cost of funding," says Hunt.

Ciaran McAreavey is the managing director of Close Brothers, Ireland, and he has also witnessed the change from 'just-in-time' to 'just-in-case' operations which pushes up inventory levels.

"This is being exacerbated by their own customers taking longer to pay. All of this results in more of the business's capital being tied up in working capital assets [ie, increased debtors and inventory without the corresponding offset of increased creditor finance]. Many businesses find themselves asset rich but cash poor, resulting in liquidity challenges even if the business is trading profitably," says McAreavey.

**■ Inflation, economic uncertainty, exchange rate volatility and supply-chain disruption are leading to concerns**

Peter Bennett, Davy's head of investment technology banking, emphasises that where short-term financing is needed it is vital to match the financing needs with comparable short-term finance. As a rule of thumb, Bennett categorises short-term requirements as about one year and long-term financing coming in at five years.

"The amount a company can borrow is typically related to the size of the cash flows. It's similar to obtaining a mortgage where the amount borrowed is matched by income. Businesses can try any number of lenders from traditional banks to specialist lenders," says Bennett.

As an adviser, Hunt advocates for better credit functions to release working capital. Faster collection of customer invoices will boost the cash position he says.

"But this is just one piece of the cash conversion cycle. There are other 'quick wins' available to free up cash. Companies should reassess invoicing processes in or-

## Contents



**Editor:** Edel Morgan
**Advertising:** Gerard Ryan 083 3150919.

der to eliminate any inefficiencies that may be causing delays in sending invoices to their customers. These inefficiencies can include manual processing, lost invoices, and a high volume of invoices to manage. Small process improvements can have a big impact on a business's working capital," says Hunt.

"In the longer term, businesses must also develop a cash culture across the entire organisation — an environment where collecting receivables, minimising inventory days and improving working capital performance as a whole is not regarded solely as the remit of the finance function but as part of everybody's role. To do this requires tighter management focus and more discipline around processes such as payables management and more stringently managing their supply chain."

Another popular method of finding short-term finance, according to McAreavey, is invoice finance. Typically, this allows a business access up to 90 per cent of the value of unpaid invoices (debtors). Unlike a traditional overdraft this type of funding grows in line with turnover, which can increase due to the impact of inflation on selling prices as well as increased activity. Invoice finance suits most businesses which sell goods or services on credit terms.

"Our asset-based lending products further extend invoice finance with funds released against other business assets such as plant and machinery, inventory and property. We can also provide top-up cash-flow loans," says McAreavey.

For longer term financing, Bennett suggests companies need to get their house in order first.

"It can be complicated and time consuming to arrange longer-term financing. There are a variety of solutions available, both domestically and internationally. Having an external expert to guide your journey can be very helpful."

McAreavey cautions matching relevant debt vehicles to each individual business.

"The appropriateness of each is unique to the business, depending on factors such as the security it can offer, the level of repayments it can afford and the volatility of its cash flow," he says.

"A loan tends to be a medium- to long-term commitment and before taking out a loan a business should be satisfied that it can meet the conditions and repayments of the loan even if the business meets unexpected challenges."

Another important point raised by Bennett is for the business to know how the proceeds will be spent.

"You'd be surprised by the number of companies that don't really know how they will spend the money once raised. I would advise they know the use of proceeds intimately.

"And to add into that mix the cost of money is becoming more expensive with the increase in interest rates. One of the biggest challenges in the market right now is the visibility of the cost of credit over the short, medium and long term. With inflation going up it makes the process of finding credit even more daunting. Definitely figure out what you are going to spend the money on — and get help," concludes Bennett.

# Technology dominates corporate finance trends

■ **Technology is front and centre when it comes to corporate finance trends**

## Companies are focused on achieving sweeping change through digital upgrades, process simplification and automation, writes **Jillian Godsil**

One of the most obvious trends dominating the financial markets is the adoption of new and emerging technologies. While it is very obvious in the retail financial sector, where fintechs are increasingly offering digital services, fintechs are also having an impact on the corporate financial sector, including how funds are raised in corporate finance, how the funds are traded and how companies get access to finance. Indeed, the pace of change is causing regulators some headache as they struggle to keep pace with innovation across the sector.

Deloitte's 2022 M&A Trends survey also puts technology front and centre in driving change.

The survey notes that companies are aiming for more transformational change, and many are focused on achieving that transformation through digital upgrades, process simplification and automation.

The same push from regulators to keep pace with technical change is pushing M&A companies to spur more deal activity as they race to beat the implementation of more potentially challenging obstacles.

According to the survey, corporate strategy, M&A strategy and operating model limitations are continuing to intersect in different ways.

Deloitte quotes surveyed executives saying that aligning these forces into a coherent approach remains one of their greatest challenges but that there are new tools to help, again including digitally-enabled, virtual and hybrid management of the M&A process.

Finally, the adoption of artificial intelligence (AI) and machine learning is set to dominate the emerging technology in finance but this is not without its issues as far ranging legislation is currently being debated in the EU and planned to come into law in late 2023.

The EU maintains the new legal framework is clear in identifying four different levels of risk: unacceptable risk, high risk, limited risk, and minimal risk, but like its approach to GDPR, this new legislation is both complex and impactful even outside EU borders.


HELPING BUSINESSES THRIVE
Close Brothers Commercial Finance provide asset based lending, invoice finance and asset finance solutions to businesses across Ireland. We can help you access the working capital you need.
Contact us today on (0)28 9099 5701 / +353(1) 901 5224 or visit closecommercialfinance.ie
Close Brothers
Commercial Finance

# Growing, growing, gone

**Edel Corrigan** on how handing over shares and relinquishing control of a business can be a difficult part of private equity for some business people

Dr Michael Smurfit once said that "equity is blood" and advised business owners to hold on to as much of it as they could. However, it is now recognised that raising capital through the sale of equity can help accelerate a company's growth. Indeed, private-equity houses have become a critically important source of capital for businesses around the world. So should businesses avail?

#### What is private equity?

Private equity (PE) is a term used to describe investment partnerships that acquire and manage companies before selling them, says Patrick Spicer, senior partner in Matheson's corporate mergers and acquisitions group. "Private-equity firms operate these investment funds on behalf of institutional and other investors.

"Private-equity funds acquire private and public companies, or invest in such buyouts as part of a consortium, and are typically differentiated from venture-capital funds in that they invest in or acquire mature companies, rather than start-ups or early-stage companies."

PwC corporate finance partner James McMenamin says private equity is an alternative asset class which invests in private companies which are not listed on public exchanges. Institutional and high-net-worth investors invest in private-equity funds as part of a diversified investment portfolio.

"Typically, private-equity funds acquire majority stakes in private companies," he says. "They get involved in the strategic management of the investee companies with a view to growing the value of the business before realising their investment after a period of, say, five to seven years.

"The strategic management can involve moving the business into new product areas or new countries, appointing key executives or digitising the business processes. The private-equity firm will usually use debt as part of the transaction structure which can enhance the equity returns on the investment."

#### Why should a company raise private equity?

A business might raise private-equity funding to support the transition of a founder looking to exit or take some money off the table and a strong management team looking to step up to a more ownership role, says John Bowe, corporate finance partner with Mazars. "It can be used for acquisitions or organic expansion plans [for example, investment in new facilities or expansion into new markets]."

David O'Kelly, head of mergers and acquisitions at KPMG, says that having the correct capital structure is one factor that enables companies to maximise their potential. "Often shareholders consider debt as the first option to grow their business. While debt is appropriate in a lot of cases, equity capital can have greater flexibility and enable companies to invest more to achieve an agreed objective.

"In addition, an interesting feature of private equity is that most transactions result in the management team receiving equity to ensure they are aligned and motivated to maximise value on a subsequent sale. This goal alignment can give a wider sense of ownership and the benefits of a common goal."

He has seen several situations where founders have grown great businesses but feel their corporate decision-making has become risk-averse as their entire net worth is tied up in the company's shares. "The personal de-risking achieved by taking cash off the table can allow founders to continue to drive their business forward without having to consider the downside risks for their family."

Peter Bennett, Davy's head of investment technology banking, says every situation is case specific and in some cases private equity is the right option, while other times it is not. "I would start with asking the question — if you were the owner of a company, what are you looking for? Do you want to sell control of your company, do you want to sell it outright, do you want to bring in a significant shareholder but someone who doesn't necessarily have control, or do you just want to bring in some investment?

"The answer to that question brings you in different directions but if you conclude that you do want to sell your company and do want to relinquish control sometimes private equity can be a good option for that."

> "Private-equity funds have taken money off the table, freeing them up to make better decisions. Another benefit is expertise, excellent contracts and experience in what has worked and has not worked in other private-equity funds portfolio companies.

#### The pros of raising PE

Bowe explains that "private-equity funds are not operators; they are there to support and often one of the immediate benefits is that it allows founders and management teams to take a little bit more risk because they are not as concerned about getting it wrong".

"Private-equity funds have taken money off the table, freeing them up to make better decisions. Another benefit is expertise, excellent contracts and experience in what has worked and has not worked in other private-equity funds portfolio companies. Private-equity funds will also put incentive plans in place for senior management, which aligns everyone to drive future growth."

#### And the cons

However, it's not all smooth sailing. Founders are giving up a level of control, says Bowe. "For people who have built their own company up from the ground, handing over shares and relinquishing part of their control can be a difficult part of private equity."

Alan Kelly, mergers and acquisitions director at Focus Capital Partners, says that by taking in private-equity investment you


■ **Private-equity funds acquire private and public companies, or invest in such buyouts as part of a consortium**

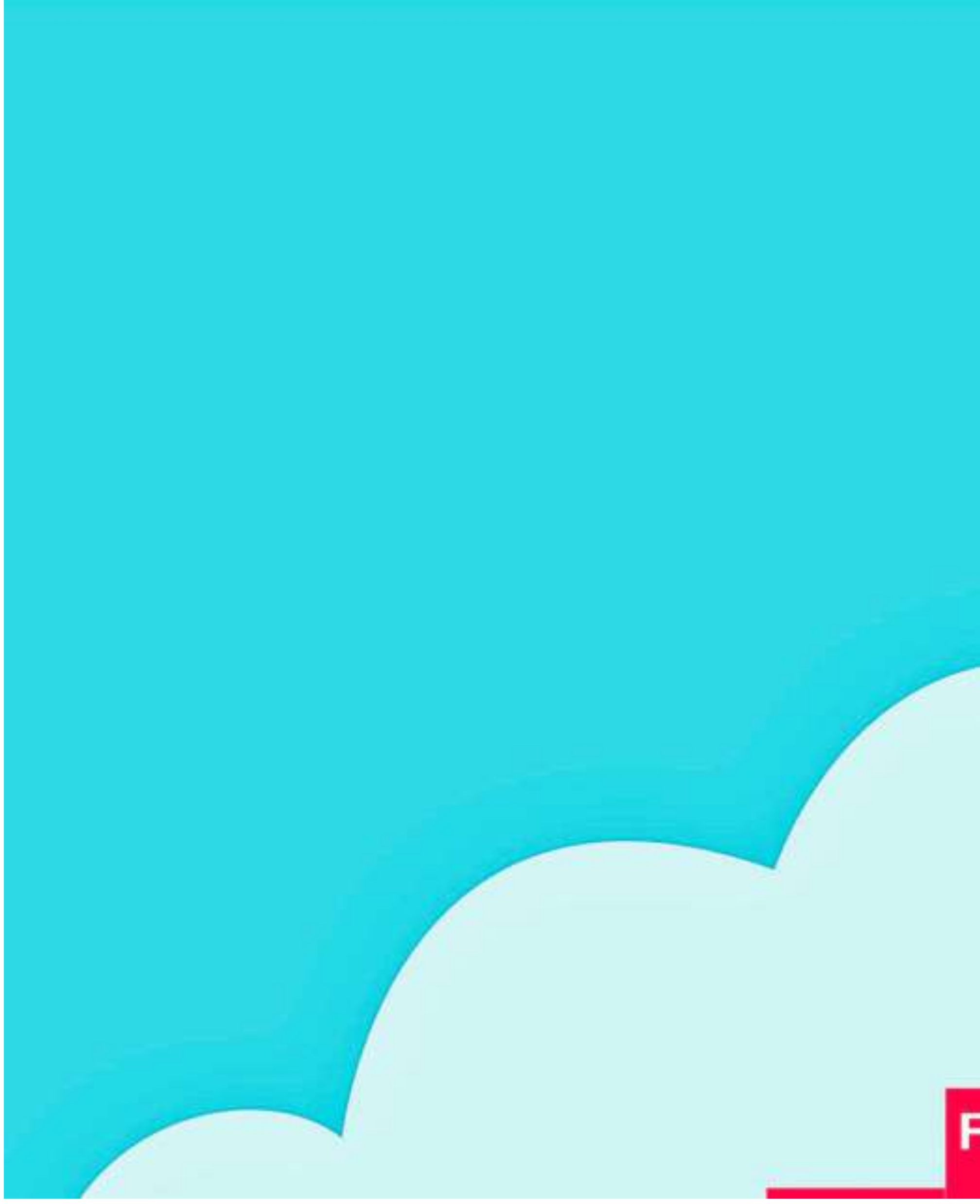
are usually starting the process of exiting the business. "The founder's equity will be diluted and with this, generally the control of the company will move to the new investors [unless the PE firm is mandated to do minority investments].

"The previous owner may no longer be the key decision-maker on certain strategic decisions. Often there will be a set of restricted transactions such as key hires or acquisitions which will require investor majority or board approval."

### Choosing the right PE

Bennett says the growth of PE has been astronomical and firms come in all sorts of shapes and sizes. "There are domestic firms as well as international firms, some specialise in particular industries, some specialise in different sizes of transactions.

"If you are considering private equity it's important to figure out who to target because some firms would be more relevant, and determining who to approach is really important because some will be relevant to you and a good fit and some are not."



# Get advice before borrowing

The issue for a lot of businesses is knowing how to navigate the changed market, writes **Barry McCall**

Just about every business needs to borrow from time to time. Sometimes it's just a bank overdraft or short time loan to tide it over periods when cash flows are tight and in other cases it might be to fund or part-fund the purchase of a new premises or the acquisition of another business. The questions tend to centre on where to get it and how much to borrow.

And when it comes to the where, the market here has changed considerably in recent years.

"The number of banks has thinned out and the number of alternative lenders and peer to peer lenders has increased," notes Naoise Cosgrove, managing partner and head of corporate finance with Crowe Ireland. "The problem for a lot of businesses is knowing how to navigate the changed market. It's difficult. There is no readymade roadmap. There is a challenge for lenders to reach their target market as well. That's where professional advisers come in."

The main banks should still be the first port of call for most businesses seeking debt capital, according to Shane O'Neill who runs the Davy corporate finance debt advisory business.

"Businesses with a good banking relationship should still prioritise their bank for debt funding but alternative providers can provide a wider product offering with more flexibility, for a price," he says. "The traditional banks have an established suite of products across commercial property and SME funding, targeting overdrafts and revolving credit facilities, term financing, invoice discounting, asset finance etc. The lending product suite of credit funds are similar but often more flexible."

Credit funds are typically backed by pension funds or private equity funds. They are not governed by the same prudential rules as banks and can be more flexible in their lending practices. "They may lend more money, can offer interest only periods, and over a longer duration," says O'Neill. "But they will price up the risk and charge more for the flexibility."

Robert Adams, managing director of Focus Capital Partners, notes the growing importance of these lenders. "Alternative lenders have developed quite a big presence in Ireland over the past six or seven years with firms like Finance Ireland, Beechbrook Capital, Earlsfort Capital, and Bain Capital all active in the market."

At the highest level, the biggest corporates now borrow directly from pension funds. "The pension funds will deal with unrated companies and will do their own ratings before lending to them," O'Neill points out.

Of course, not all debt is the same. "The most common forms of debt capital available to businesses are term facilities with regular principal repayments over the life of the loan; revolving credit facilities in which the drawn amount rises and falls in line with a business working capital profile; asset-backed loans which are generally secured against a company's assets be they accounts receivables, inventory or machinery and equipment; and unsecured overdrafts," explains Jeremy Hoare director - debt advisory, corporate finance at KPMG Ireland.

Hoare says it is important to ensure there is alignment between the form of debt utilised and the proposed use of the funds. "For example, the acquisition of a fixed asset, such as a new factory, should ideally be funded via a facility with a longer term so that the repayment of the facility can be spread out and the ultimate cost met by the anticipated returns generated by the asset. Similarly, short-term or ad-hoc funding requirements should be met using sources of finance which are flexible and able to be drawn on short notice and on multiple occasions."

Then comes the question of how much debt to take on. And businesses may not have a lot of choice in this due to the rules and guidelines applied by the credit institutions.

"There are two main types of lending," Adams points out. "Secured lending and cash flow lending. Generally, cash flow lending is calculated on a multiple of EBITDA (earnings before interest tax depreciation and amortisation), usual around three or four. You can get mezzanine funding on top of that up to a multiple of twice EBITDA. Unitranche lending is a blend of the two giving between four and six times earnings."

> "There is no magic formula in establishing the correct level of debt, The appetite for increased financial risk associated with the proposed level of leverage will differ from one business to the next

Those rules don't necessarily apply to secured lending which is usually repaid over a long term. "In asset backed businesses like hotels or nursing homes which own real estate, the level of gearing can be higher," says Cosgrove. "Loan-to-value is king in those cases."

"There is no magic formula in establishing the correct level of debt," says Ciaran McAreavey, managing director with Close Brothers. "The appetite for increased financial risk associated with the proposed level of leverage will differ from one business to the next.

Fundamentally the business needs to assess the impact the repayment schedule of the debt will have on its projected cash flow. The assumptions around the projected cash flow need to be subjected to intense scrutiny and sensitivity analysis."

He also points to another key measure of gearing, the 'debt to equity' ratio which is calculated as the gross financial debt divided by shareholders' equity. "A typical rule of thumb used by banks and lenders would be that a ratio of less than 1.0 is low and above 2.0 is high, with a ratio above 1.5 starting to make the lender consider whether the level of leverage is justified by the business."

And those limits may be academic in any event. "Poor recent historic trading has become a significant factor for companies

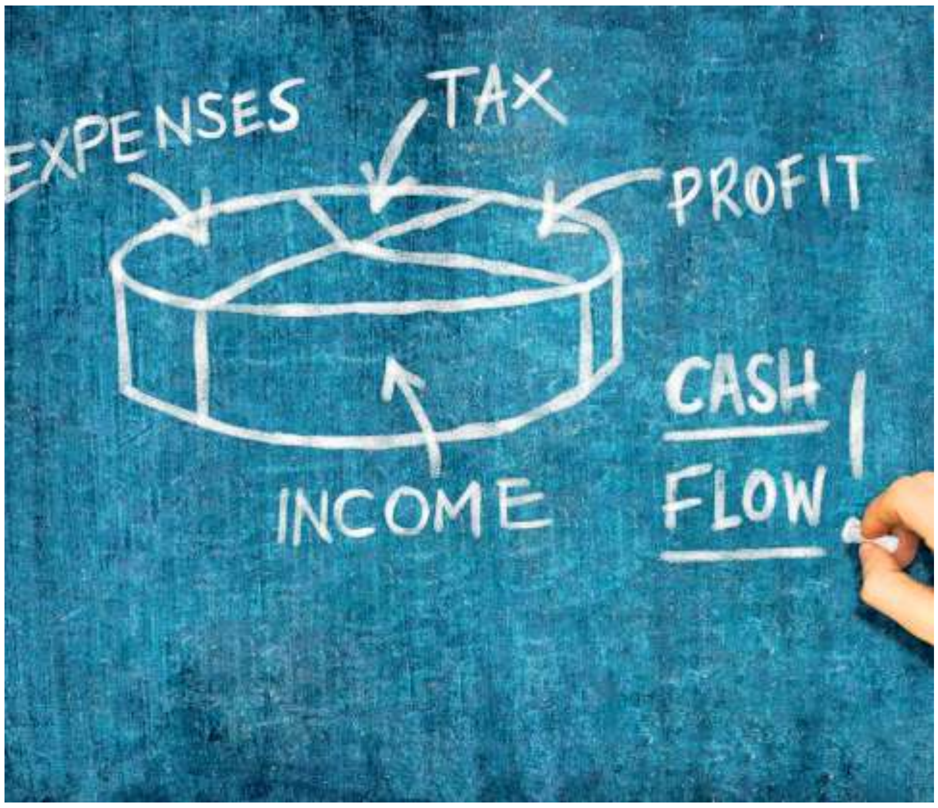

seeking to borrow at present as Covid-19 impacts their credit profile even if the business has bounced back," O'Neill explains. "Combined with reduced asset prices and a weaker economic outlook, this makes debt raising more challenging."

The increase in interest rates is also having a negative impact. Adams explains that the interest rates being paid on loans will have effectively doubled by the end of the year as a result of the increase in ECB base rates. This will affect a business's debt service cover ratio – the level of debt it can afford to service. "This will significantly reduce the amount of loan capital available to businesses," he adds.

Cosgrove advises businesses to get professional advice before borrowing. "Find out what lenders will and won't do," he says. "It might be better to use a mix of funding types. There is a lot of work involved in raising funding. It's not a quick process. Professional advisers can help with that."

**Just about every business needs to borrow from time to time.**

# Every SME should calculate a cashflow statement




It's advisable to create a new cashflow plan every month or quarter and this will help keep track of finances, writes **Sandra O'Connell**

Cash is king for Ireland's SMEs, but right now it's under royal pressure. Inflation, interest rate rises, the energy crisis, and supply issues are all putting pressure on costs, with fears of a rise in late payments not far behind.

"The inflationary environment is having a direct impact on the payment cycle through an increase in costs such as inventory, interest, wages and fuel, which businesses are not always in a position to pass on to its customers," explains David Ahern, director, corporate finance in KPMG's Cork office.

Revenues have been impacted by a number of factors including disruption in the supply chain, which leads to delays in the securing of inventory required to generate sales in a timely manner, he points out. "The rise in the cost of living could lead to a reduction in consumer demand, which in turn would result in lower sales. This can then create a wider knock-on effect in the wider economy as businesses impacted with cash flow restraints can be then slower to make payments to other businesses, which can then place those business under cashflow pressure."

So what can businesses do?

"Every small and medium-sized business (SME) should calculate a cashflow statement and forecast, identifying what the cash needs of the business are. These will typically include fixed costs, such as rent, insurance, telephone and broadband services, and variable costs including taxes, PRSI and operational expenses," says Stephen McCarthy, head of business development at Bibby Financial Services.

"Having a forecast will allow you to more easily see where potential savings can be made, such as by reducing or postponing non-essential services. It's advisable to create a new cashflow plan every month or at least quarterly, depending on your circumstances, and this will help better control cashflow."

Consider your customers' and suppliers' own financial position as well. The Covid-19 pandemic and the energy crisis has meant that many businesses are experiencing payment delays, and this inevitably has knock-on effects throughout the wider supply chain as the cash conversion cycle lengthens, McCarthy points out.

If possible, maintain diversity across your customer base. This may be easier said than done, he admits, especially as the full effects of the energy crisis on businesses' ability to operate begins to be felt, "but ensuring a wide customer base will limit your exposure to bad debt and enhance cashflow," says McCarthy, who recommends not having more than 20 per cent of your business with one customer, as losing that business would represent a sizeable hit to your income. The non-bank lending sector has proliferated here since the financial crisis. The upshot for SMEs is that there are now more alternatives to traditional bank finance than ever.

Many, such as Bibby, specialise in products such as invoice finance, which allows businesses to raise cash against unpaid invoices, providing an immediate and ongoing supply of cash that grows with a business. Up to 90 per cent of the value of an invoice can be paid within 24 hours – allowing business owners to pay staff, suppliers, or take on new orders. "Because it is not a loan, it doesn't involve any additional debt, helping to keep cashflow healthy. Equally, unlike taking out a business loan, there are no fixed monthly repayments involved," says McCarthy. "Ultimately, improving your business's cashflow is a crucial step in surviving and thriving, allowing you to realise new opportunities, take on new orders or expand and invest in your business." According to Ciaran McAreavey, managing director of Close Brothers, in the current environment many businesses are facing the challenge of their suppliers seeking payment in advance or reducing credit terms. "Furthermore, lead time from suppliers is increasing, requiring many businesses to move away from a "just in time model" to a "just in case model" and pushing up inventory levels. This is being exacerbated by their own customers taking longer to pay. All of this results in more of the business's capital being tied up in working capital assets – that is, increased debtors and inventory without the corresponding offset of increased creditor finance. Many businesses find themselves asset rich but cash poor, resulting in liquidity challenges even if the business is trading profitably," cautions Mr McAreavey.

> "Ultimately, improving your business's cashflow is a crucial step in surviving and thriving, allowing you to realise new opportunities, take on new orders or expand and invest in your business

The rise in the cost of living could lead to a reduction in consumer demand, which in turn would result in lower sales. PHOTOGRAPH:ISTOCK

Invoice finance can release capital tied up in debtors. "Unlike a traditional overdraft this type of funding grows in line with turnover, which can increase due to the impact of inflation on selling prices as well as increased activity," he points out.

Invoice finance suits most businesses which sell goods or services on credit terms. "Asset based lending products further extend invoice finance with funds released against other business assets such as plant and machinery, inventory and property," adds McAreavey.

# The rollercoaster ride of start-ups

It's not easy for start-ups to raise capital but Irish businesses are fortunate to have access to a good funding ecosystem, writes **Barry McCall**

■ **Early stage capital raising is not a linear journey.** PHOTOGRAPH:: AGENCY STOCK

One thing that high-growth start-up companies have in common is a thirst for cash. Fast-growth companies, particularly in the tech and life sciences sectors, need lots of money to develop products and services, prove concepts, build teams and enter markets.

And there is no point in going to the bank for the money. It's not just the risk involved, these companies typically have little or no sales income and absolutely no capacity to repay loans. That leaves them with little option but to trade some of the equity in the business for investor funding.

"Servicing debt can restrict growth, and equity is often a more optimal solution when seeking to scale rapidly," explains Niall Flood, managing director with KPMG's corporate finance practice. "Advantages of equity over debt include accelerating growth, raising higher quantums and the value-add provided by venture and private equity funds such as stronger boards, access to new customers, and a focus on maximising value on exit. Venture debt is also an option but is conventionally used in conjunction with venture capital in specific circumstances and to minimise founder dilution."

Early stage capital raising is not a linear journey, according to Conor Carmody, investment consultant with Furthr. "There are lots of ups and downs. The founder probably starts off with an idea, and then moves on to building early prototypes and needs funding for that. We are fortunate to have quite a good early stage funding ecosystem in Ireland with the Local Enterprise Offices, the New Frontiers programme, the Enterprise Ireland Competitive Start Fund, and organisations like Furthr. For most people who are still at the stage of trying to understand if what they have is more than an idea, funding comes mainly from these sources as well as family and friends. They want to validate the idea and see if customers are willing to pay for the product or service."

After that comes the seed round where professional investors come into the mix. This typically involves about €500,000 funding. Carmody points out that many high-potential Irish companies get seed funding from Enterprise Ireland which is a very significant player in the seed and venture capital market here.

"They might go to business angels and venture funds as well around that time," he adds. "This is typically risk capital to take the company through the next 18 months of its development. Investors are happy to fund the business while it builds out its team and test markets products and so on."

Then comes the veritable alphabet soup of funding series rounds beginning with A. "Seed and series A rounds differ across all the key headings," says Flood. These headings include the scale of the funding raised – €3 million-€5 million for series A as opposed to €500,000 upwards for seed rounds; evidence of traction in the market; and the funding sources used.

"Series A is the first of a number of rounds a company might go through," Carmody adds. "They may go back to existing funders looking for additional investment and some of them might choose to cash out and sell their stakes on to a subsequent investor when the company's value has increased. Companies go through each round to fund each phase of its earnings growth and development. The founders may well exit and sell up to bigger companies before going through the full funding journey."

The benefits for companies and their founders are obvious, but they still have to give up a share in their business. However, as Carmody explains, they might have to give up 25-30 per cent of a company worth very little in order to raise €500,000 in seed capital and within a few years the business could be worth €1 million or €1.5 million. A very worthwhile trade indeed. And the rewards get bigger as the funding journey goes on.

The attraction for investors is much the same. "Very early investors at pre-seed or seed stages may be bought out later," Carmody notes.

"If the company is valued at €2 million at series A stage, it could be €10 million-€12 million by the next round. That's a very significant gain. Of course, many venture capital investors will have multiple investments and many of them won't do very well, they are looking for the superstars to pay for the others which weren't so good."

# Vendor loans should be a last resort

Vendor financing can give rise to certain tax considerations that also need to be carefully considered, writes **Sandra O'Connell**

You want to sell your business. How far should you go to help someone to buy it?

"Ideally what you want when you are selling is to sell 100 per cent of the asset for 100 per cent of the value at the same time. So vendor finance is not at all common," says Peter Bennett, head of investment technology banking at corporate financial adviser Davy.

"It should be seen as a last resort made to get the deal done. It's a useful tool where a situation occurs that you have a single buyer who is a very compelling buyer in all respects other than a lack of finance."

That most commonly means management buyouts. "MBOs typically require either external capital or the vendor is more patient about receiving its proceeds. Vendor loans can create a win-win situation for some sellers as MBOs can be less disruptive to the business and managed appropriately can allow the successful transition of a business from one generation of executives to another," says David O'Kelly, head of M&A at KPMG.

But vendor finance might also arise "where all other buyers have disappeared and you are left with just one, but that single buyer doesn't have the means to reach the amount you want", says Bennett. "You'd also often see it is where a company is selling a division."

Sellers may wish to provide a vendor loan where they have to sell their business or part of their business at short notice, perhaps for regulatory reasons, and there isn't time for purchasers to raise sufficient third-party funding to execute a transaction, says Laura Gilbride, director PwC corporate finance.

"While typically described as loans, they usually have characteristics which are more akin to equity. The loan will rank behind senior debt and may have an increasing rate of interest which encourages the purchaser to repay the loan sooner," she adds.

"In situations where there is a formal process, the market will set the value range for the business. In bilateral situations, both the buyer and seller will initially come up with their respective positions and from there attempt to negotiate an agreed price. Where the price ends up depends on the relative strengths of each party," says Gilbride.

Each situation is unique and vendor finance should be assessed on a case-by-case basis, says David Cairnduff, a director of accountancy firm Crowe. "It generally works best where the vendor will retain some role in the business post-sale or where the vendor is financially secure and is happy to defer an element of the consideration."

It is important to agree the commercial terms of the loan at an early stage, including the repayment timeframe, cashflow waterfall if other lenders are involved, and any security which will be available to support the loan.

"Vendor finance is, in effect, a form of deferred consideration attached to the deal. Ensuring that there is an appropriate level of upfront consideration paid by the purchaser and that the deferred element is not contingent on future performance targets or thresholds will mitigate your exposure," he says.

Make sure the security package attached to the loan is robust. "In the event of borrower default, it will be important that you have the capacity to recover your loan in the same manner that a third-party lender would have. This could be in the form of a charge over all shares in the business, and personal guarantees from the borrowers," adds Cairnduff.

> Vendor finance is a useful tool where a situation occurs that you have a single buyer who is a very compelling buyer in all respects other than a lack of finance

The structure of such transactions can bring challenges for both parties.

"Expensive interest payments on the vendor financing can weigh on the business being sold and prevent the business from having sufficient capital in the future to further invest in the business," points out Brian McCloskey partner in law firm Matheson's Corporate M&A Group. "From the seller's perspective there is a risk that the performance of the target business deteriorates and there may be a delay in having the vendor financing repaid or in a worst-case scenario, the seller is never repaid."

Vendor financing can give rise to certain tax considerations too that need to be carefully considered. These include the ability of the seller to avail of CGT "rollover relief" on a disposal of a portion of their shares not being sold for cash. Says McCloskey: "In addition, certain provisions may need to be considered which, in certain circumstances, can recharacterise share proceeds as distributions for Irish tax purposes which can impact the seller's tax position and the buyer's withholding tax analysis."

Buyer's beware, vendor finance could see the seller seek to restrict the new owner's ability to run the business autonomously for the period in which the vendor financing is outstanding. That, he cautions, may hinder the buyer's ability to expand the business over time.

# A sound (re)structure

## Where can businesses in need of restructuring find financing? asks **Edel Corrigan**

■ **Even strong businesses aren't exempt, as some areas may be underperforming while others may require investment if they are to meet their potential**
PHOTOGRAPH: AGENCY STOCK

There comes a time over the course of a business when it may need to be restructured. Even strong businesses aren't exempt, as some areas may be underperforming while others may require investment if they are to meet their potential. This process can be daunting and often means closing parts of the business and job losses, although the ultimate objective is to preserve the business, and as many jobs as possible. For most instances of restructuring, it involves refinancing the business. For businesses that might be facing a restructure, where can they find finance?

### Restructuring

There are many reasons why a business may need to restructure, says Ken Tyrrell, business restructuring partner, PwC. "Some of the more common reasons are an external market shock, competition, an unexpected change in regulation or legislation, overtrading, acquisitions not performing or a fundamental change in market demand. Companies don't always necessarily engage in restructuring under duress. It can also happen while preparing for a sale, merger, transfer of ownership or a strategic redirection."

### What does it involve?

"While all vary on a case-to-case basis, a restructuring process will generally involve cashflow forecasting, working capital management, rapid cost reduction, developing and executing restructuring plans," says Tyrell. "Complex stakeholder management and communication planning is an integral part of any successful restructuring process. For complex restructurings, companies may seek to engage a turnaround manager or chief restructuring officer [CRO] to oversee the restructuring process."

### Financial restructuring

When a business owner is looking to engage in restructuring activity, they are also extremely anxious to keep the level of borrowed money to a minimum, says Stephen McCarthy, head of business development, Bibby Financial Services Ireland. They simply don't want to take on term debt or cashflow loans that will result in monthly repayments for years to come.

"When considering restructuring, there is a range of alternative finance sources that businesses can consider, depending on their requirements, including invoice finance, grants, fintech, venture capital, angel investors, peer-to-peer lending and crowdfunding. Obviously, the best solution for the business could even be a mix of these options, such as a short-term term loan with a traditional bank combined with some investment and an invoice finance facility."

Financial restructuring essentially involves putting a debt and equity structure in place that supports a business's restructuring plan, meets all liabilities as they fall due and supports any new strategic initiatives, says Tyrrell. "It will generally involve stakeholder management with external parties such as lenders and, potentially, shareholders. If there is a crisis element to the financial restructuring, this is typically when companies will seek to look at formal restructuring options such as schemes of arrangement, examinership and other formal insolvency procedures."

### Starting the process

One of the first things to try to understand is to what extent either financial restructuring (balance sheet) and/or operational restructuring (profit and loss) is required given the issues facing the business, says Tyrrell. "Once that is understood, it helps focus the attention on the key areas in the development of a restructuring plan.

"A business will need to clearly show that taking on additional debt in the short term will actually be beneficial for the business over the coming years. For example, it may allow funding the closure of a business unit which was loss-making but will ultimately improve the profitability of the business."

To do this, a comprehensive business/restructuring plan with supporting cashflow forecasts will be the fundamental document to share with a lender, Tyrrell says. "Similarly, if a business needs to refinance from an existing lender, this information will be needed to support any discussions seeking funding from potential new lenders."

# Financing M&As is an obstacle course

Structuring a deal involves weighing up the benefits of various types of debt and equity finance, writes **Danielle Barron**

For many businesses that want to grow, the optimum route is through the acquisition of other businesses. Financing M&A activity can be an obstacle course, however, with funders keen to see the requisite due diligence has been done before agreeing to back any deal. Meanwhile, the sheer scale of the deals can often mean a mix of funding methods is necessary.

There is no magic formula in determining the right financing structure for a business or a particular deal, says Ciaran McAreavey, managing director of Close Brothers Ireland. "It is more a combination of factors and attitudes. Structuring a deal involves weighing up the respective costs and benefits of various types of debt and equity finance and trying to strike the right balance."

David O'Kelly, head of M&A at KPMG explains that the cost of an acquisition is often larger than normal growth and the size of transactions can require that different avenues of financing are explored. "We have funded deals through a broad range of sources including senior debt, asset backed loans, mezzanine finance, equity and vendor loan notes," he says. "The correct mix needs to be judged on a case by case basis depending on the risk appetite and priorities of shareholders and the working capital needs of the combined business."

"Most forms of debt funding are cheaper than equity but increasing the amount of debt in a funding structure will come with an increasing cost, repayment terms, financial covenants, conditions and security," McAreavey notes.

"Close Brothers can provide working capital and term debt facilities on a standalone basis and has successfully worked with other specialist lenders and equity providers to provide businesses with the complete funding package they require to complete an acquisition."

Another factor in M&A funding is that it needs to be arranged at deal speed, O´Kelly adds. "Acquirers that are not sufficiently funded will find it challenging to get into pole position for attractive targets. As such, there is much greater time pressure than might exist in a business as usual scenario."

The process is complicated by the broad range of factors that funders seek to understand before signing on the dotted line and the depth of review will differ by the type of funding, O´Kelly says. "While debt funding will entail thorough preparation and diligence, equity funding is a riskier asset class and as a result has elevated diligence levels," he says.

According to Robert Adams, managing director of Focus Capital Partners, the key thing that funders look for before backing an M&A deal for growth is the management team. "They normally look for ambitious management teams who have a good plan for the combined business and who have been successful within their own business," Adams explains.

> "Most forms of debt funding are cheaper than equity but increasing the amount of debt in a funding structure will come with an increasing cost, repayment terms, financial covenants, conditions and security

"This plan can have synergies that can be taken from both businesses, opportunities for cross selling within the merged businesses and much more."

The levels of debt being used to acquire the business will be important to the funder, he adds. "There will generally be an element of equity required to complete the acquisition by the funder. This can be in the form of cash equity or it could be value built up within the existing business that is looking to acquire."

Many companies and shareholders start with the assumption that they will debt finance M&A, he notes. "However, it is important to consider the restrictions that elevated debt places on a business and to be mindful of the risk appetite of shareholders. There is an abundance of equity options available in the market and most shareholders should be able to find partners that will help them meet their objectives."

Stephen McCarthy, head of business de-

velopment at Bibby Financial Services Ireland, says it is no surprise that M&A is firmly on the agenda for many Irish businesses at the moment. Recent research by Bibby Financial Service showed that 35 per cent of Irish SMEs were actively considering M&A, MBO or MBI activity in 2022.

Once restricted by a lack of options for funding growth, business owners can now look to fund growth through a variety of financial solutions. McCarthy says Irish SMEs are now actively looking for a hybrid mix of funding to fuel their M&A activity.

"What SME owners don't realise is that they don't have to give away equity, dilute their shareholding or take out a loan to fund growth – they could instead use a self-financing option such as invoice finance to facilitate the required growth," he explains. "Our research shows that just over one fifth (21 per cent) of Irish SMEs plan to use invoice finance to fund their M&A transactions, while just under a third are looking to fund these transactions with business loans. Many also tell us they just don't want to have to take out a loan to finance a restructuring transaction."

Invoice finance is a method of financing where a business owner is given access to any outstanding invoice amounts due – often in the millions – and this money can then be used to help fund transactions such as M&A, MBI or MBO's. Several sectors are engaging in this activity to release equity to fund any executive transactions, include manufacturing, logistics, MedTech, advertising, recruitment, printing, professional services and hardware, McCarthy notes.

"This option obviously reduces the debt burden, provides additional working capital while also avoiding the need to give away any equity in the business. As well as providing the required liquidity to finance the initial contribution, it can then be used on an ongoing basis to provide essential working capital to allow the business trade-on successfully without any cash flow concerns," he says, adding that Bibby Financial Services Ireland is now working with Permanent TSB to offer these and other funding solutions to businesses.

Corporate finance firm Crowe specialise in mergers and acquisitions for the SME sector. Naoise Cosgrove, managing director, says it is important to strategically review the range of options available to finance an acquisition by assessing the internal and external funding required. "This should be done at an early stage in the process."

**■ Just over one fifth of Irish SME's plan to use invoice finance to fund their M&A transactions**

The funding landscape for business has changed significantly in recent years, he notes. "While historically, high-street banks were the main source of finance for M&A transactions, there are now a wide range of alternative lenders in the market. There is a vibrant private equity market with funds who are interested in investing alongside owners and their management teams."

Some key factors that influence the type of funder to approach include the amount of funding required, the tangible security available, the level of gearing in the combined business, the repayment plan and overall growth prospects. "Before embarking on the due diligence process you should build a strong and compelling business case for the purchase. It is important to outline the business plan for the acquisition, and how the integration will be managed, the synergies to be achieved and future growth prospects for the enlarged business," Cosgrove advises. "The objective of the due diligence exercise should then be to gain a deeper understanding of the target business and ensure that it is as presented to you."

Ultimately a funding partner will be examining the return that they can achieve from the investment and the level of headroom within the business plan, he adds. "If the funding is in the form of debt, this will be influenced by the level of free cash flow generated by the business and the time horizon over which it is paid. For an equity investor, the return will be assessed based on the credibility of the exit plan and growth targets for the business. An independent professional advisor should assist in presenting the relevant business case and navigating the funding market."

# For what's next in a net zero world

Together, we'll help you respond to the climate agenda.

kpmg.ie