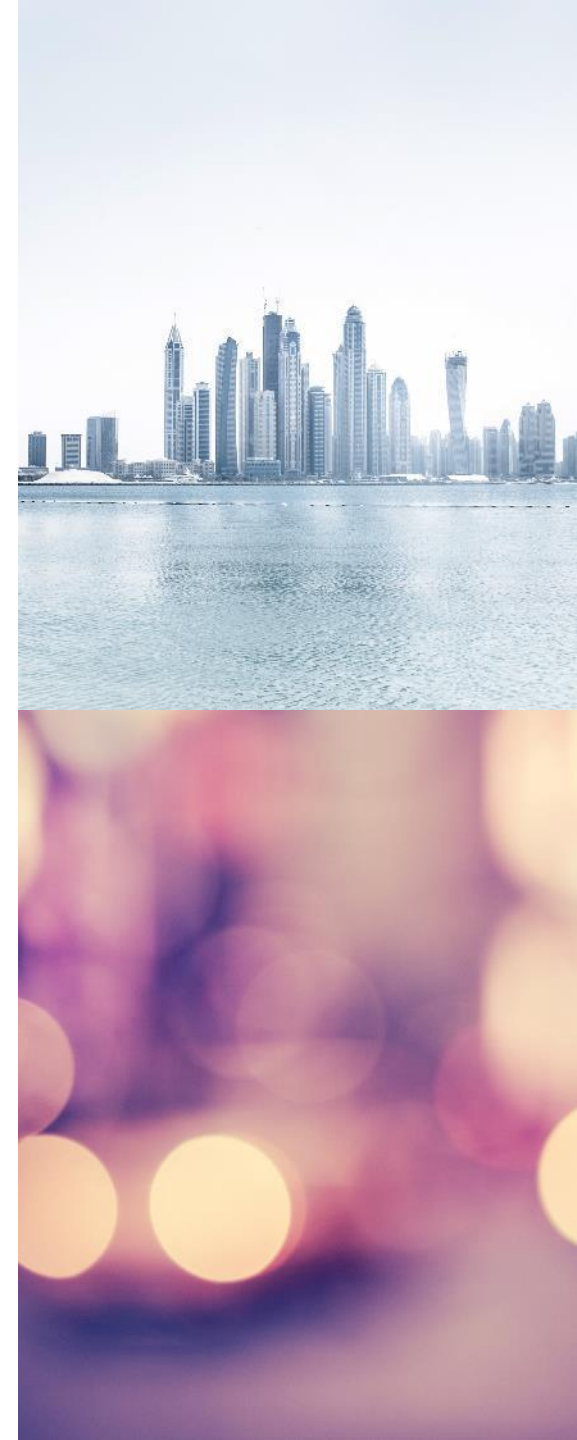




# Introduction to Acquisition Financing

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# 1. Introduction to Acquisition Financing

## 💡 What is Acquisition Financing?

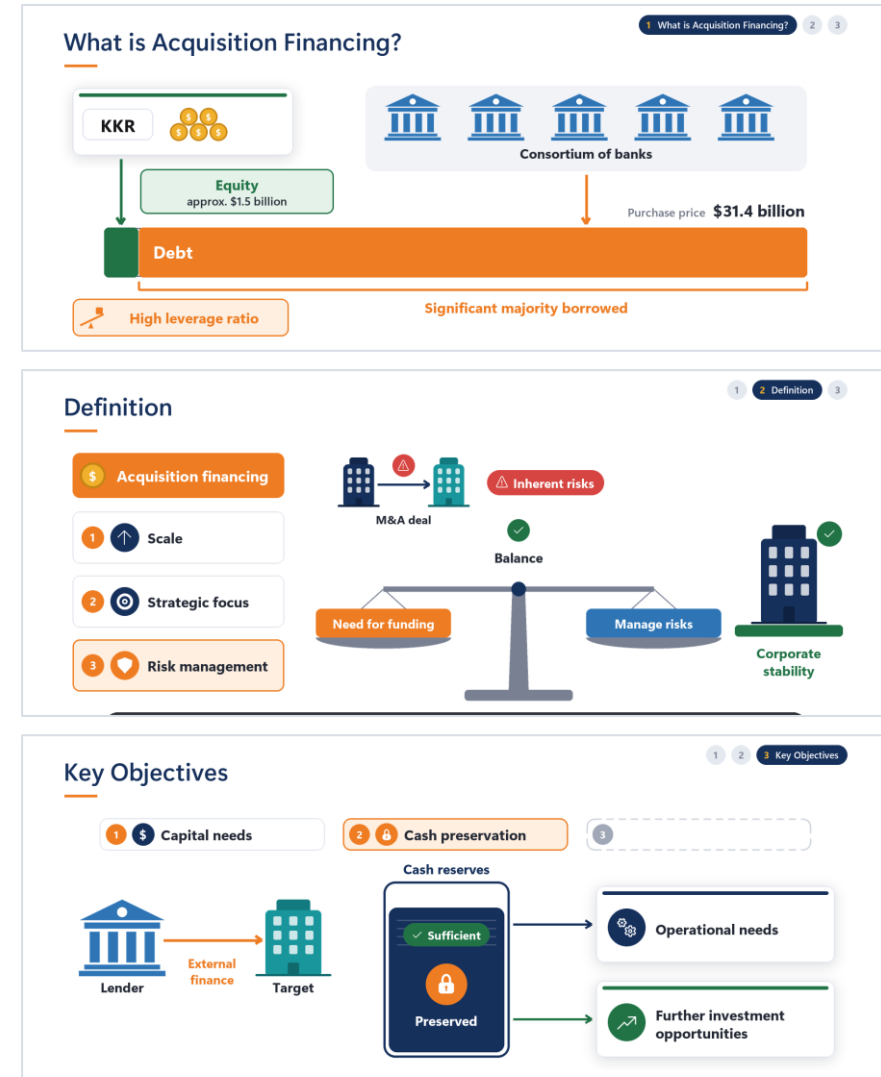
- In 1989, KKR acquired RJR Nabisco for \$31.4 billion.
- It was one of the largest leveraged buyouts ever.
- KKR invested approximately \$1.5 billion of equity from its fund.
- A consortium of banks financed the remainder with debt: high leverage.
- This strategic use of debt magnified the returns on KKR's equity.

## 📘 Definition

- Specialised financing tailored to the unique needs of M&A transactions.
- Goes beyond standard corporate finance to secure the necessary capital.
- Funds the purchase of a company or a significant part of its assets.
- Scale: substantial capital, complex structures and careful risk assessment.
- Strategic focus and risk management: objectives balanced with corporate stability.

## 🎯 Key Objectives

- Capital needs: fund outlays beyond the acquirer's internal capabilities.
- Cash preservation: keep reserves for operations and further investments.
- Maximising IRR: cheaper external capital creates a leverage effect.
- Less equity and more debt enhance IRR, a common private equity tactic.
- Amplifies returns and allows diversification across multiple acquisitions.



# 1. Introduction to Acquisition Financing (Part 2)

## Key Financing Sources

- The right mix of financing sources is fundamental to a successful acquisition.
- Three key options: debt, mezzanine and equity.
- Each has unique characteristics and a role in the deal structure.

## Debt Financing: The Backbone

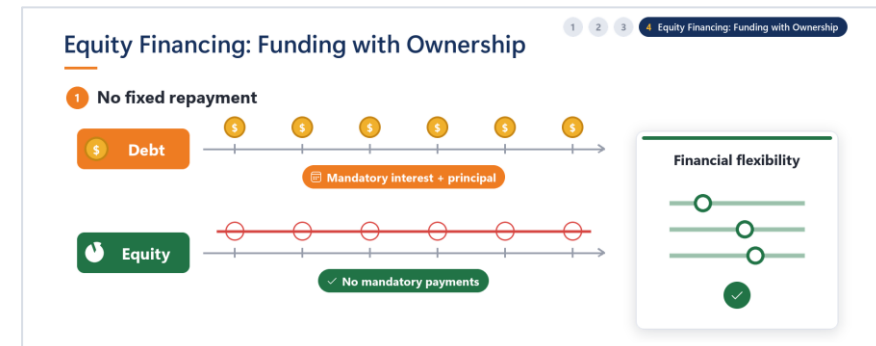
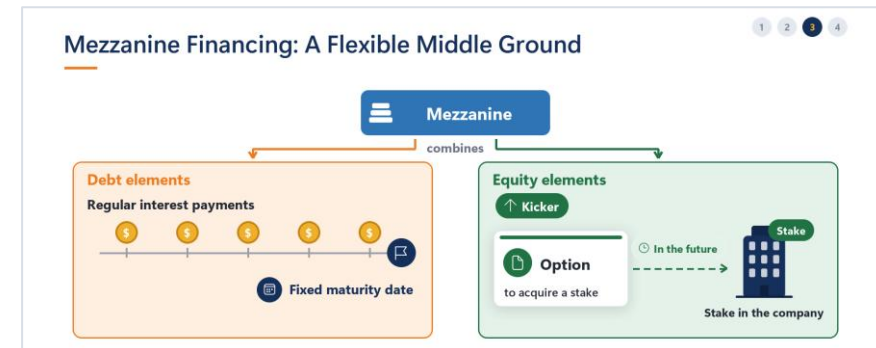
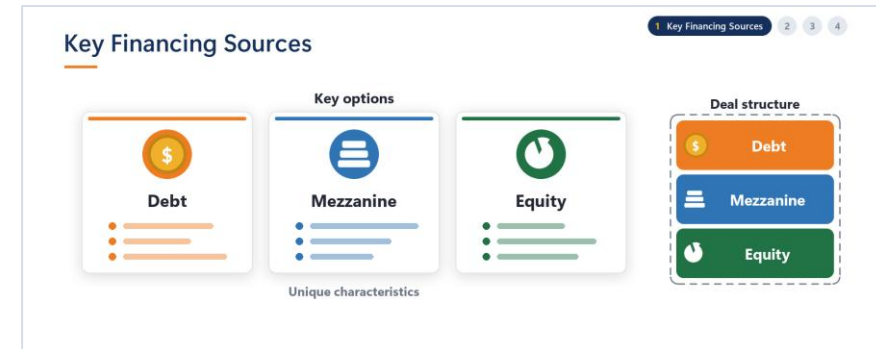
- Borrowed from banks and institutional investors, or raised by issuing bonds.
- Generally secured by the target's assets or other corporate assets.
- Contractual repayment: regular interest and principal on a fixed schedule.
- Seniority: in a default, debt holders have priority over equity holders.

## Mezzanine Financing: A Flexible Middle Ground

- Sits between debt and equity on the risk spectrum.
- Debt elements: regular interest payments and a fixed maturity date.
- Equity elements: kickers such as an option to acquire a future stake.
- Hybrid form: more than traditional debt, less control given up than equity.
- Costlier than senior debt, but flexible and used to bridge financing gaps.

## Equity Financing: Funding with Ownership

- Selling shares raises funds, dilutes ownership and needs no repayment.
- Attractive when high growth is expected and profits can be shared.
- No fixed repayment: no mandatory interest or principal payments.
- Ownership stake: rights to future profits and a say in decisions.
- Investors expect higher returns for more risk, with high upside if successful.



# 1. Introduction to Acquisition Financing (Part 3)



## Debt vs. Equity Considerations

- Acquirers must decide between debt and equity financing.
- Key factors: cost, flexibility and impact on ownership.
- Each financing type has specific advantages and trade-offs.



## Debt Financing

- Borrowed from banks, investment banks or insurance companies.
- Lenders receive regular interest and principal on a predetermined schedule.
- Advantage: cost-effective, particularly when interest rates are low.
- Interest is tax-deductible, reducing the net cost of borrowing.
- Disadvantage: more leverage raises default risk; fixed repayments limit flexibility.



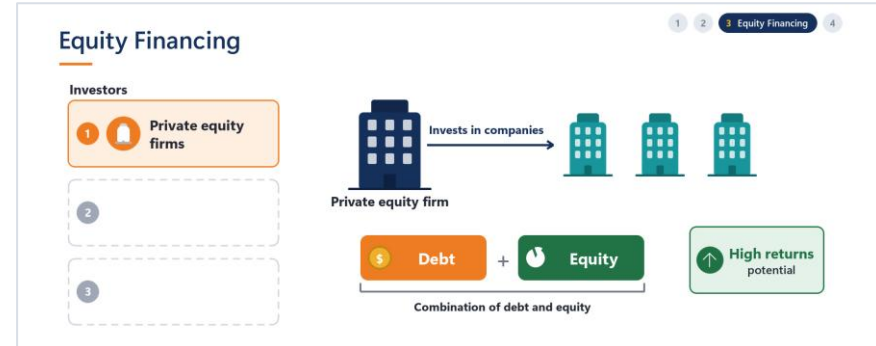
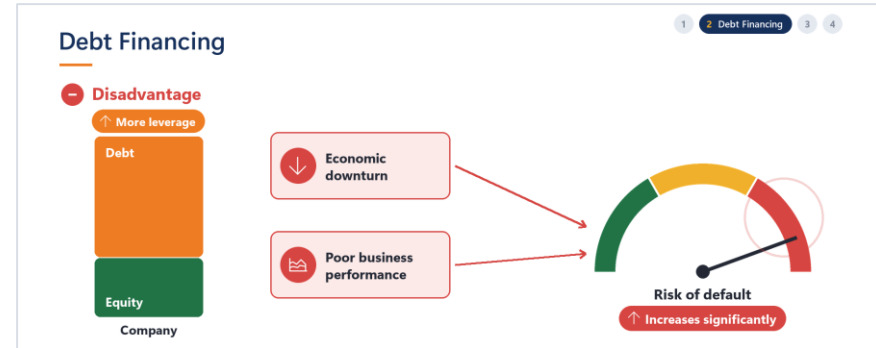
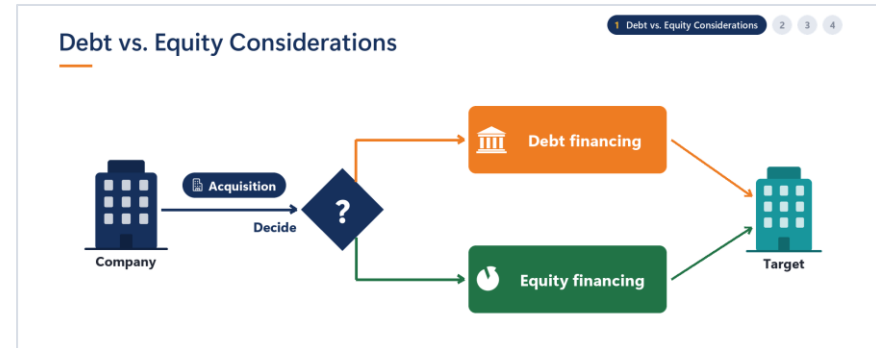
## Equity Financing

- Raises capital by issuing new shares of stock.
- Investors: private equity firms, strategic investors and public markets (IPO).
- Advantage: no mandatory interest or principal payments, more flexibility.
- Wide pool of funds without collateral, ideal for asset-light or high-growth firms.
- Disadvantage: dilutes existing shareholders; investors expect higher returns.



## Strategic Considerations

- Prefer debt: mature companies with stable cash flows benefit from lower cost.
- Prefer debt: the target's tangible assets can serve as collateral.
- Prefer equity: high-growth potential makes sharing future profits attractive.
- Prefer equity: need for flexibility or less predictable cash flow.



# 1. Introduction to Acquisition Financing (Part 4)



## Understanding Key Dimensions of Financing (part 1)

- Each financial instrument used in M&A has its own specific characteristics.
- Key dimensions: repayment priority, maturity profile and cost of capital.
- Also examined: possibilities for amortisation and the specialisation needed for sourcing.



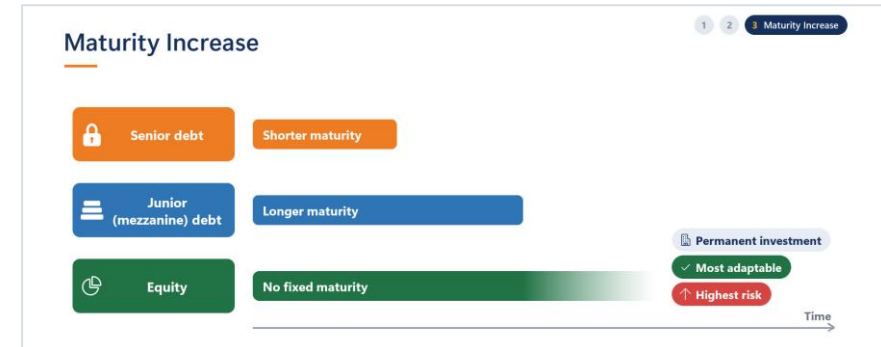
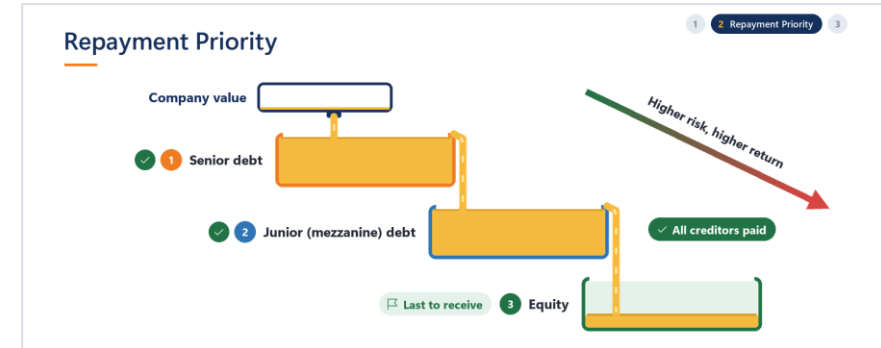
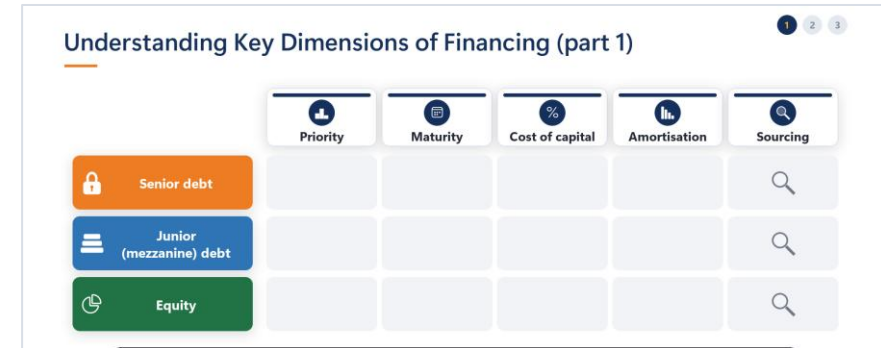
## Repayment Priority

- Sets the order in which creditors are paid in liquidation or bankruptcy, shaping risk and return.
- Senior debt is paid first and is the least risky, usually secured by collateral.
- Junior (mezzanine) debt is paid after senior debt and carries higher risk.
- In financial distress, junior debt is less likely to be repaid in full.
- Equity is paid last but has the highest risk and higher potential returns.



## Maturity Increase

- Maturity length generally increases from senior debt to equity.
- It correlates with the level of risk investors are willing to accept.
- Senior debt: shorter maturities, lower risk and quicker recovery of investment.
- Junior (mezzanine) debt: longer maturities, increased risk, potentially higher returns.
- Equity: no fixed maturity, a permanent, adaptable but highest-risk investment.



# 1. Introduction to Acquisition Financing (Part 5)

## 💰 Cost of Capital

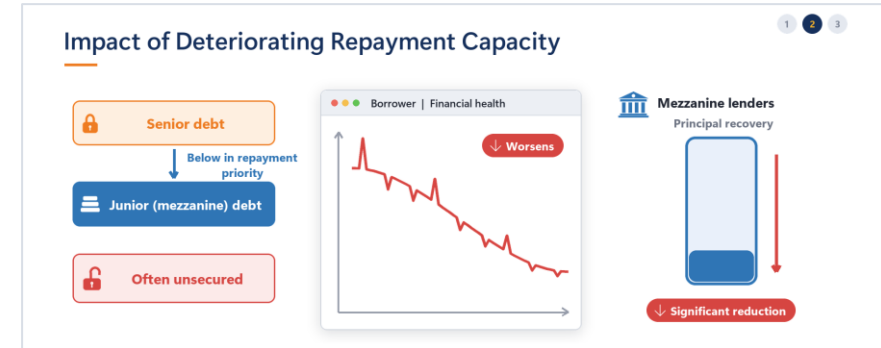
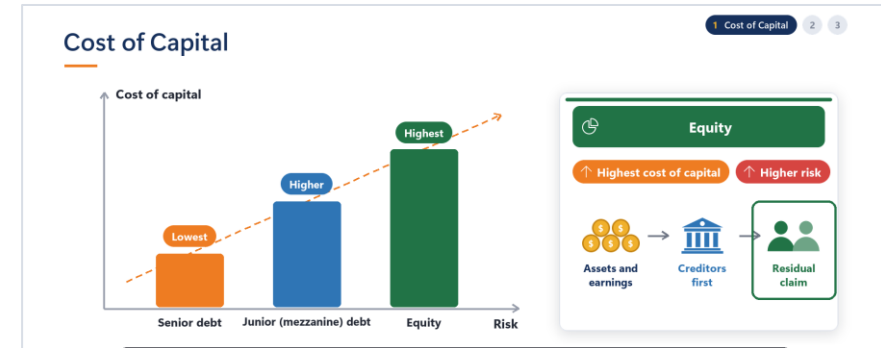
- The return lenders or investors require to compensate for their risk.
- It generally increases as the risk of the investment type increases.
- Senior debt: lowest cost, due to higher repayment priority and lower risk.
- Junior (mezzanine) debt: higher cost, reflecting its subordinate position.
- Equity: highest cost, given the risk of its residual claim on assets and earnings.

## 📉 Impact of Deteriorating Repayment Capacity

- As repayment ability deteriorates, principal recovery varies by instrument.
- Senior debt is the most protected: secured, with priority, so recovery rates are higher.
- Junior (mezzanine) debt ranks below senior debt and is often unsecured.
- If financial health worsens, mezzanine lenders face a significant cut in principal recovery.
- Equity investors recover last, as owners rather than creditors, and may lose everything.

## 🎯 Specialisation of Sourcing

- Sourcing demands knowledge of market conditions and risk-return profiles.
- Senior debt: credit analysis, market interest rates and covenant negotiation.
- Covenants balance lenders' protection with the company's operational flexibility.
- Mezzanine: complex terms and kickers; cash flow projections and risk tolerance matter.
- Equity: valuation skills, articulating value creation, matching investors' risk appetite and time horizon.



# 1. Introduction to Acquisition Financing (Part 6)

## Case Study

- Two real acquisitions show contrasting uses of debt and equity financing.
- Dell and EMC used debt; Salesforce and Slack used equity.



## Case Study 1: Dell's Debt-Fuelled Acquisition of EMC

- In 2016, Dell acquired EMC, a data storage and IT infrastructure leader, for \$67 billion.
- Funded mainly with debt: about \$50 billion in bonds plus additional bank loans.
- Total debt rose to over \$60 billion; no shareholder dilution, Michael Dell kept control.
- EMC's cash flows were leveraged to service the new debt.
- Dell became a major IT infrastructure player, but high leverage pressured its balance sheet.



## Case Study 2: Salesforce's Equity-Driven Acquisition of Slack

- In 2020, Salesforce acquired Slack for \$27.7 billion to grow cloud and workplace communication.
- New Salesforce shares covered the majority of the transaction cost.
- Equity preserved cash for operational flexibility and avoided adding debt stress.
- The trade-off: dilution for existing shareholders.
- Stronger position in digital collaboration; financial impact remains mixed.

