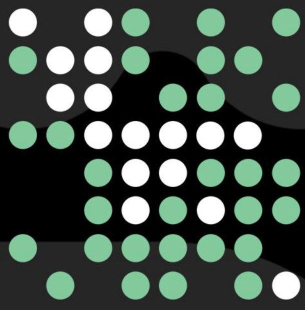


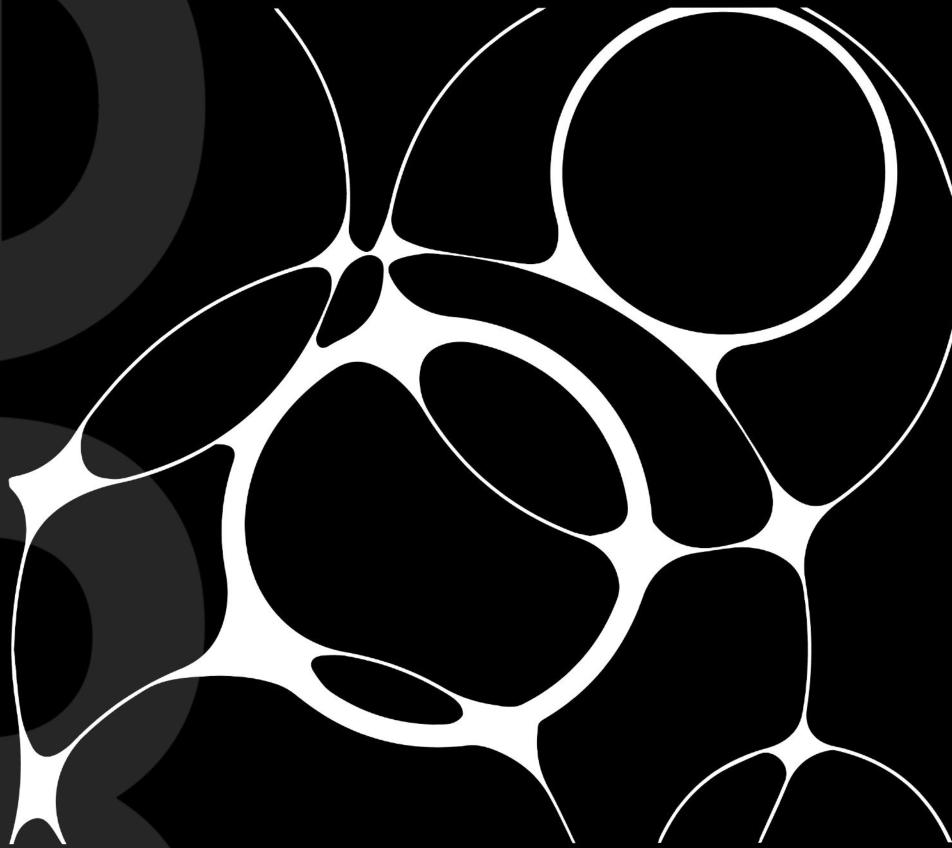
combuyn

Special Issue

EUROPEAN M&A MAGAZINE
CREATED BY

Fusions & Acquisitions
La première revue des rapprochements d'entreprises

M&A REVIEW
MERGERS & ACQUISITIONS • Beteiligungen • Allianzen • Restrukturierungen • Divestments • Private Equity
www.ma-review.de



Private equity IPEM edition

© Ilias Ben Chemsi Graphiste

UNLOCK YOUR GLOBAL POTENTIAL.

WITH LATHAM.

AUSTIN · BEIJING · BOSTON · BRUSSELS · CENTURY CITY
CHICAGO · DUBAI · DÜSSELDORF · FRANKFURT
HAMBURG · HONG KONG · HOUSTON · LONDON
LOS ANGELES · MADRID · MILAN · MUNICH · NEW YORK
ORANGE COUNTY · PARIS · RIYADH · SAN DIEGO
SAN FRANCISCO · SEOUL · SHANGHAI · SILICON VALLEY
SINGAPORE · TEL AVIV · TOKYO · WASHINGTON, D.C.

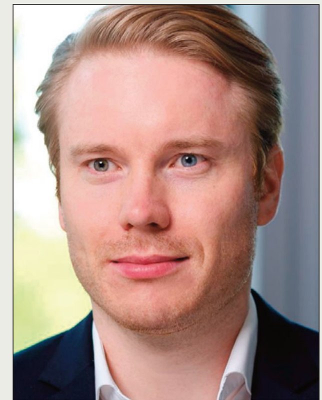
LATHAM & WATKINS LLP

combuyn
IPEM SEPTEMBER - 2023

BUY-AND-BUILD STRATEGY: SUCCESS FACTORS AND BEST PRACTICES FOR GERMAN INVESTORS

Sibylle Münch

by Sibylle Münch and Dr. Maximilian Platzer, Latham & Watkins


Dr. Maximilian Platzer

LATHAM & WATKINS LLP

High interest rates and rising financing costs continue to challenge private equity investors' platform deals in Germany and across Europe, but buy-and-build transactions have barely been affected. As German private equity firms chart succession and consolidation deals, there are still lucrative opportunities for investors to buy assets. A buy-and-build strategy is worth considering, even if an investor initially only intends to acquire a single asset. The further acquisition of companies and businesses in the same or a complementary segment can lead to economic benefits for the acquiring group that exceed the sum of the individual acquisitions. Investors who have the foresight to arrange credit facilities in advance are in a strong position to execute their deals quickly, reduce documentation costs, and increase transaction security. Preparing a credit documentation to enable a complex buy-and-build strategy requires close collaboration between lenders, borrowers, and their outside counsel. This article highlights the key considerations for German investors planning a buy-and-build transaction strategy.

- ***Securing Acquisition Facilities***

To implement a successful buy-and-build strategy, sufficient funding is critical, ideally in the form of acquisition facilities. However, a lender's willingness to offer such a facility depends on a borrower's ability to demonstrate that their intended acquisitions fit the lender's risk profile. So structuring the buy-and-build strategy from the outset is critical, considering decisions such as: In which geographical regions can purchases be made? In which business areas and industries? Up to what size? How can the borrower group's leverage develop — for example, can it exceed a certain threshold for a limited time? Can the acquired EBITDA of the target company be added pro forma for purposes of testing the leverage ratio of the group? Can any synergies resulting from the purchase be added to the EBITDA on a pro forma basis? Do these criteria also apply to the purchase of further shares in a subsidiary in which the borrower already holds the majority of shares? The acquisition facility should also provide sufficient flexibility for the borrower's intended use: this includes financing both the acquisition and the transaction costs, as well as the options for refinancing the target's debt and the investor's equity if the purchase was temporarily pre-funded with the equity injected by the private equity investor.

A committed acquisition facility is subject to a commitment fee payable to the lender of around 30-35% of the applicable interest margin. In addition to the volume of committed acquisition facilities, the financing documentation should allow the borrower to secure additional facilities without obtaining additional consent from the lenders which remain uncommitted in the beginning. These incremental facilities that lenders have not yet committed do not yet incur a commitment fee, but a borrower must first find a lender that is willing to join the documentation and to commit the funds. In this context, the borrower should prepare a collateral package that from the outset provides for any increases in the obligations to be secured, so as not to require costly (and possibly notarial) collateral confirmations for each increase or new facility made available.

► ***Reinvestment***

Sellers do not always intend to sell all of their shares to an investor, and investors regularly want to continue to incentivize the sellers to generate additional investments after the initial acquisition. An attractive option may be to offer a reinvestment to each seller of a target company through a joint holding company. This can be structured in a tax-efficient manner via a so-called "share rollover," in which case the seller sells and transfers only a portion of its shares for a cash purchase price and agrees to contribute the remaining shares in exchange for new shares in the new holding company. This approach not only incentivizes the seller economically, but can also create an ongoing emotional connection between the seller and both its sold target company and the combined group. However, such a participation of third parties can lead to a "change of control" under the credit documentation which usually provides for strict protection of the "single point of enforcement" requiring the acquisition vehicle to remain a wholly-owned subsidiary of its holding company and furthermore requires the private equity investor to remain majority-invested. If taken care of during negotiation of the credit agreement, seller reinvestments and share rollovers can be permitted and thereby avoiding a change of control. A change of control usually triggers the requirement for a loan to be repaid in full; therefore borrowers should prepare the credit documentation to accommodate for a seller reinvestment and share rollover (the latter limited for a short period of time).

► ***Meeting a Guarantor Coverage Ratio***

Lenders generally require that all companies acquired with the proceeds from the credit agreement accede as guarantors to the credit agreement and provide asset security. For complex buy-and-build structures that could lead to a large number of companies being required to accede to the credit agreement. To meet this challenge, parties in the leverage finance market for acquisitions usually agree on a guarantor coverage concept: the companies that provide guarantees and collateral must jointly represent a certain percentage of the EBITDA of the group. The exact coverage level, usually 70-85%, is agreed at the beginning of the transaction. As the share may change at each acquisition, the credit documentation will determine whether the group must test at each acquisition or only annually on the basis of the annual financial statements, as well as whether and to what extent the guarantor coverage level will need to be maintained. Agreements vary, but at a minimum, an annual testing is required. If the consolidated EBITDA represented by the guarantors is below the agreed percentage, additional group members must accede as guarantors. Material companies which contribute — depending on the agreement — 5-10% to the group EBITDA, usually have to accede as guarantors irrespective of the guarantor coverage ratio. As a best practice, a higher threshold for small-scale buy-and-build transactions should be agreed.

► ***Timing Compliance With Criteria***

As borrowers pursue transactions within the scope permitted by the credit agreement, questions arise as to when they must meet specified criteria: When signing the purchase contract? At the closing of the acquisition? At both times, usually several months apart? From the borrower's perspective, transaction security should be considered and compliance should be tested either at the time of signing the purchase contract or at the time of closing — at the discretion of the borrower. As a rule, the borrower must also prove the leverage ratio is not exceeded even if an acquisition is added pro forma. The borrower must determine whether it would have complied with the leverage ratio at the previous quarter date when the leverage ratio was tested if the acquisition had already been carried out. The credit documentation will also provide for how EBITDA of the group and the target company should be calculated and whether any synergies resulting from the purchase may already be included on a pro forma basis. Further "adjustments" to EBITDA (or its derivation) are regularly the subject of negotiations. The same applies to the maximum amount of adjustments (usually 20-25% of the adjusted consolidated EBITDA with uncapped or capped exception items).

Lenders may also require borrowers to forecast whether the agreed leverage ratio levels will be complied with after the acquisition has closed. Again, the timing of the review is critical: if the test is upon signing, the financial condition of the company may still permit the acquisition; if it is not until closing, the situation may deteriorate — in the worst case such that the necessary criteria for the acquisition are no longer met. Regardless, the acquisition vehicle is bound by the purchase agreement after signing. It might also be the case that the acquisition criteria are not met when the purchase agreement is signed but will be met at closing. In any event, borrowers would be sensible to agree flexibility.

In order for borrowers to maintain sufficient leeway, negotiating a short-term buffer to the applicable leverage thresholds is advisable if the agreed headroom does not provide sufficient certainty. However, a so-called acquisition spike will generally only apply to the four fiscal quarters following the acquisition. After that, the original leverage ratio levels must be met again.

► ***Efficiency Through Standardized Documentation***

In order to shorten a transaction timeline and thus allow the seller to minimize interruptions to business operations, investors should focus on standardizing purchase and participation documentation from the outset. For example, sellers may agree that the buyer (i.e., the investor) prepares the first drafts of the purchase contract and the other essential transaction documents. These are typically based on sample contracts developed for the group and therefore can be generated and delivered quickly. This repeatedly simplifies negotiations and coordination, since the internal coordination between the investor and outside counsel is streamlined and investors can develop standard positions on topics relevant to the seller. Investors, particularly in buy-and-build scenarios, typically work with outside counsel from large firms with the resources to quickly prepare contracts based on precedents. This approach and the reduced outlay of documentation costs is appealing to a seller, especially if transaction security is not yet at 100%.

Investors should also always carry out a cartel analysis for transactions in Germany or the EU, even in smaller add-on acquisitions. In addition to the financial and tax integration of the target company into the combined group, a legal integration should be carried out on an ongoing basis after closing. Investors can also gain efficiencies with these analyses, for example by using standard contracts for the entire group (e.g., employment contracts, supply contracts, purchasing contracts, etc.) as well as by implementing a group-wide compliance management system with uniform data protection guidelines.