Leveraged Acquisitions: A New Post-Credit Crisis Structure

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In the current uncertain and fast-moving financing environment, recent transactions demonstrate that acquirors and targets, sharing a desire to complete a deal, can move beyond the pre-credit crisis leveraged deal model involving financing commitments, to develop a new paradigm for allocating financing risk.

Financing commitments today, when obtainable, often are more conditional than the terms agreed between the principals. They may also be of shorter duration than what is needed to consummate the transaction and have pricing and other "flex" terms allowing the banks to alter terms to facilitate selling-off the debt. While pre-credit crisis leveraged deals generally required buyers to draw down committed financing even if the lenders flexed pricing and covenants to the maximum allowed, buyers may not be prepared to accept that result based on the condition of the financing commitment market today. In short, commitments may no longer "match" deal terms, making them a less helpful tool in persuading the seller that the buyer is in fact committed to complete.

While banks are understandably cautious about bridging the signing-to-closing period with certain funds, corporate and private equity buyers can sometimes obtain superior financing terms simply by going to the capital markets immediately prior to closing. To mitigate financing risk, sellers can require covenants that ensure that the buyer will go to market, and will borrow funds subject to agreed (or better) terms. In effect, the financing term sheets that would have been attached to the bank commitment instead become a schedule to the purchase agreement. An appropriate "financing failure" termination fee and rigorous obligation to obtain financing subject to the expressed terms can provide the seller with extensive comfort that the deal is not an option for the buyer.

A recent example is the May 2010 acquisition of Tommy Hilfiger by Phillips-Van Heusen. Phillips-Van Heusen committed to close the transaction if it obtained financing meeting minimum terms (including weighted average cost of capital) agreed between the parties. Post-signing, both parties promptly worked to complete the financing, which included bank lending, as well as a note offering, an equity offering and a private placement of preferred stock. The transaction closed approximately 45 days later. This structure is also being used in the pending merger between Mirant Corporation and RRI Energy, Inc.

Which transactions may be the best candidates for this approach? Deals with short time periods between signing and closing that afford greater visibility of the financing markets. Sellers with an in-depth understanding of the capital markets are more likely than others to be comfortable that they can "keep the buyer honest." Ultimately, which buyers and sellers will accept this approach and the risk of an announced deal that does not complete will depend on how compelling the transaction is for the parties.

Dealmakers can hope that bank commitments will one day return to some reflection of their former selves; in the meantime, sophisticated acquirers and targets can digest financing risk and use deal creativity to reach an optimal result.