Key Aspects of Planning Low-Cap/Mid-Cap M&A Deals

Mergers and Acquisitions (M&A) encompass numerous subtleties that require detailed consideration of the deal planned, its funding procedure, the distribution of roles within the buyer's team, setting of deal-breaking 'red lines' which, if reached, may force buyers to abandon the deal. Additionally, M&A deals involve negotiation procedures with sellers, agreement on the size of the acquired stake in the company's capital (100%, 51%, stake required for a qualified majority), and evaluating the risks if sellers stay in the company's capital or, conversely, if sellers completely exit the business while understanding that the business might heavily depend on specific selling shareholders.

There can never be too many questions in such transactions. The principle of "legal minimalism" – the reluctance to conduct a detailed analysis of all possible current and future risks – is a very shortsighted approach to solving any long-term tasks, including in the field of M&A transactions. Large companies, institutional investors know this and spare no resources on thorough preparation for mergers and acquisitions. This brief review is dedicated to transactions in the SME sector and touches upon some key aspects that buyers should consider at the beginning of any M&A deal in the small and medium-sized enterprises sector.

Assessing Financial Capabilities of Purchase

When talking about SME sector deals, we understand that information about the potential deal price of a non-public company can be obtained either directly from sellers or due to some connections with the target company and its owners (for example, in the case of an MBO deal when the buyers are the target company's current top manager). The quoted or assumed price might not in and of itself tell much to the buyers – a business can be bought for one ruble, while it could have a debt or financial liabilities of several billion rubles. The first task is to obtain information about:

(1) the desired selling price and the package of shares being sold;

(2) the way the price calculation is approached by the sellers, for example, "we assume that the price equals EBITDA multiplied by the X multiplier" or "we own unique assets / IP rights / have other competitive advantages, etc., and we value them at Y rubles", a combination of these or other factors; and

(3) debts and obligations of the target company, as well as the volume of its highly liquid assets (money on accounts etc.).

Based on this information, the buyers need to understand how the payment of the deal's price will be funded before the negotiations begin: by use of personal funds, by combination of personal and borrowed funds, at the expense of future cash flows of the target company (as in the case of MBO deals), etc.

If there are several buyers, an agreement must be reached on the specific shares acquired by each buyer.

Acquired Package Size

What package of shares is being sold? Which package is preferable to purchase: 100% of the charter capital (authorized and issued shares), a controlling stake of 51%, or a package that provides for making decisions requiring a qualified majority?

The acquisition of 100% of the shares provides the buyer with unconditional control over the target company and over the making of any decisions, but it also implies larger investments. Acquiring a controlling stake or a package that allows making decisions requiring a qualified majority will be cheaper. However, this also means that buyers will have to consider the interests of the remaining, minority shareholders, which can lead to conflicts of interest and contentious situations after the purchase.

Buyers do not always have the option to choose the size of the stake they are acquiring, but when such a choice is available, the decision should be guided not only by its cost but also by the strategic tasks of the parties. Certain knowledge may also include the order of payment for the transaction price: (1) a lump-sum payment, in full at the moment of title transfer, (2) in parts, or (3) in parts, when the second part, for example, is calculated based on a formula depending, again for example, on the operational indicators of the target company at the end of an agreed period. It is important for buyers to weigh the advantages and disadvantages of each option, and making a successful decision will depend on a comprehensive analysis of potential risks, security mechanisms, and the investment horizon.

Choosing the Transaction Structure

The key question is the procedure for buyers' entry into the transaction: directly as individuals or through a legal entity. This choice significantly affects the purchase and its subsequent execution:

- Direct participation in the target company endows an individual owner (participant or shareholder) with direct voting rights, eliminates the administrative barriers inherent in the "individual — holding company — target company" ownership chain, reduces the information gap between the target company and the owner, and allows for an optimal tax structure for the purposes of dividend receipt or profits distribution;

- Direct ownership can also have its drawbacks or may simply be impossible: not all individuals are ready to disclose their participation in a specific business; if a buyer needs a loan for the deal financing, it's advisable to take the loan on a legal entity to avoid personal asset liability etc.;

- In case there are two or more buyers, risks associated with the management of the target company after the deal implementation arise: in one case, buyers can participate in the target company directly (as a physical or legal entity), vote based on the size of their share in capital, and bear risks if the shares are insufficient for making a desired decision; in another case, buyers can make a corporate agreement and move the decision-making on issues related to the target company's operations to the level of the agreement, thereby reducing the risks of failing to reach an agreement in circumstances envisaged by the agreement; in a third scenario, buyers can agree to enter the capital of the target company through a single holding company and make necessary decisions in the target company as a single member (shareholder);

- In case a loan is needed for the purchase finance, a creditor (lender) can require the creation of a single holding company — the buyer: administering the loan (credit) is simpler for the creditor if it is provided to a single legal entity, and the creditor can demand joint liability of the holding's owners to secure the holding's performance under the loan (credit);

- From a tax planning standpoint, the purchase of the target company by an intermediary holding company may entail double taxation at the target company level and at the holding level before profit distribution or the payment of dividends to the final beneficiaries;

- What to do if one of the buyers is unable to pay for their share but is a valuable specialist and does not agree to reduce their potential share in the target company? The deal structure must account for such circumstances, including the procedure for financing the shares of buyers participating in the ‘sweat equity’ scheme.

The list of questions above is not exhaustive. There are genuinely many questions regarding the structure. A well-thought-out structure guarantees the preservation of good relations with the sellers, within the buyer team, and in the relationship with third parties (creditor and other stakeholders of the deal), as well as minimizes financial losses.

Corporate Governance after Acquisition

Buyers might consider the question about implementing corporate governance after carrying out the deal premature in the early stages of an M&A transaction. However, it’s desirable to think about this as early as possible, especially in a situation when there are several buyers in the deal and none of them plan to or can acquire a controlling stake. How will voting occur? What issues might be vitally important for buyers and require a unanimous decision or a decision from a qualified majority? For instance, if after completing the project the target company doesn’t have sufficient funds and needs money to replenish working capital or finance capital expenditures, what should be done? Parties to the corporate agreement can provide for the possibility of appealing to the shareholders for capital by increasing the share capital, or they can establish the principle that any additional financing will be done through external loans (credits).

Legal and Tax Consequences

Buyers in the SME sector, especially those financing the purchase with their own funds, are extremely careful about ‘non-core’ expenses. However, it’s recommended to adequately assess the legal and tax consequences of the project for buyers, the target company and even sellers, at the early stages of M&A transactions. Expenses on consultants can be minimized by dividing the task into parts, making the first bit a general analysis of the deal structure and an assessment of possible risks. Remember a simple rule – the more you save on consultants and comprehensive analysis at the beginning of the transaction, the more you will spend on legal representation and compensation for losses in the future.

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