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“Loan to Own”

How to Acquire Good Businesses With Bad Balance Sheets

*“Smart Business” by Matt McClellan*

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# SMART BUSINESS

INSIGHT. ADVICE. STRATEGY.™

## Loan to own

### *How to Acquire Good Businesses With Bad Balance Sheets*

*By Matt McClellan*

In today's economic climate, many businesses are struggling, and lending institutions aren't extending credit as freely as in the past.

And that can present an opportunity for investors to take control of a company without buying it outright, providing capital to a business that needs money to continue operating.

"Business owners often view control as related to ownership of the company," says Matthew R. Zakaras, a partner with Levenfeld Pearlstein, LLC. "But you can often control a company through leverage by buying its debt (preferably at a discount), or issuing new debt because, as a secured lender, your consent is required to sell the business. In addition, loan documents can contain covenants that require the lender's consent for major decisions. Loan-to-own opportunities arise most often when the target is in a distressed situation, i.e., when debt is putting tension on an otherwise profitable business. A loan-to-own strategy can be the first step in a transaction that enables an acquirer to unlock value in a debt-burdened company."

Smart Business spoke with Zakaras about the viability of the loan-to-own strategy and the steps to taking control of a distressed business.

### What is 'loan-to-own,' and how does it work?

There is nothing new about loan-to-own strategies; we are just seeing more of them given the economic climate and the lack of available financing alternatives. Loan-to-own strategies are used by private equity and other investors to purchase companies as an alternative to conventional asset, stock or merger transactions.

A lot of times, loan-to-own transactions are utilized because the target business needs working capital and cannot obtain financing from conventional lending sources. Investor-lenders are looking to structure the transaction to reduce downside risk. For this reason, the investment is structured as a secured loan so that the investor-lender is among the first to be paid in a liquidation or bankruptcy of the target.

Also, these investors are sometimes looking for a toehold position in the company. The investment may be small in the beginning, but it often increases as the target continues to need working capital for survival. As more money is loaned, the investor-lender gains more control of the target.

Loan-to-own strategies are also used when a target's balance sheet shows more liabilities than assets and the secured lenders are unwilling to release their liens because they will not receive full value at closing. Acquirers are often in a better position dealing with the secured lenders of the target directly, rather than negotiating through the company that has been unable to meet its debt service obligations.

Once the acquirer buys the secured debt of the target, it has control over the sale and can often negotiate a lower purchase price with the target because, as a secured lender, the acquirer can also foreclose on the target's assets if the purchased debt is in default.

### **When would a business owner use loan-to-own strategies?**

Usually, business owners are forced into the situation because they either need working capital, or they are unable to sell their business because there is more debt than assets on their balance sheet. Ultimately, it comes down to leverage: How can an acquirer structure a transaction to reduce risk, obtain control and capture maximum value?

### **What are the steps involved, and what are the different types of strategies?**

The steps in a loan-to-own transaction vary on a transaction-by-transaction basis, and, as we discussed earlier, there is nothing new about the loan-to-own strategy. If the investor-lender is loaning money to the target, the loan documentation is very similar to any other secured loan.

The investor-lender will want extensive representations and warranties, and covenants related to the target's business. The investor-lender will also want the right to foreclose on the target's assets in the event of a default.

When the investor-lender purchases the debt, there is a loan purchase agreement, and the important thing to remember is that the investor-lender is stepping into the shoes of the original lender, and so its remedies vis-à-vis the target are contained in the loan documentation that the target negotiated with the original lender.

In both situations, the investor-lender may need to coordinate its efforts with, and may need to subordinate its position to, the target's senior lender.

### **What should investors look for when determining if using a loan-to-own strategy to purchase a company is a sound investment?**

Investors ultimately need to look at the underlying business fundamentals of the target. Like any other transaction, the investor needs to ask himself, 'Does this company have a reason to exist?' If so, the investor should look at the target's balance sheet to determine what debt can be shed to make the target more profitable.

The investor-lender also needs to understand the value of the target, and where the investor-lender stands in line in the event of a bankruptcy or liquidation. This understanding also underlies the price points that are negotiated with the secured lenders and the target. It is no different than buying a company through any other type of asset sale, stock sale, etc. Investors still need to conduct proper due diligence. In the acquisition of distressed companies, it is important to understand the debt and capital structure of the target as it relates to its value and the amount of the investment.

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