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Rising interest rates could mean even more M&A deals structured with cash and equity

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What to consider when structuring a cash and equity transaction

We have enjoyed low interest rates for years, leading to an increase in all-cash acquisitions. As valuations soared in 2021, we saw private equity firms seeking to mitigate risk by requiring sellers to roll a higher percentage of equity than ever before, sometimes at 50% levels and above.

Mixed cash and stock deals have remained a common deal method, particularly for larger transactions. With interest rates on the rise, we could see even more of these mixed offerings, with more stock offered as borrowing cash becomes more expensive.

Rather than bridging the valuation gap with just an earn-out, private equity firms can structure equity on a subordinated basis for sellers and management, sometimes imposing a senior PIK dividend on top of the junior equity.

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As with any deal method, offering a mix of cash and stock comes with a mix of risks and rewards for both the buyer and the seller, and mixed offerings must be carefully structured to protect both parties. There are legal, tax, and accounting implications that must be taken into consideration when structuring these deals.

While all-cash transactions can be faster and usually present fewer roadblocks along the way, from a buyer's perspective, there are several benefits to offering more stock in a mixed transaction. First, it can be a good option for buyers who do not have enough cash or are looking to reserve cash for further growth. Equity offerings also prevent the buyer from going into additional debt should they not have all the cash readily available.

These two points can be essential for larger transactions, helping buyers protect cash flow and significantly decrease debt incurred. Preserving cash can also be particularly important to buyers looking at expansion who need to preserve cash on hand to fund organic growth and new initiatives.There are downsides for buyers as well when offering more stock than cash. With an all-cash transaction, there is a complete change in ownership. It is more of a seamless transition where the buyer assumes complete control of the company. When offering equity in addition to cash, the buyer does dilute some of their ownership. The greater the percentage of cash in mixed offerings, the greater the ownership for the buyer and the more control they have moving forward.

On the seller side, the greater the stock offering, the more they can share in the rewards from the future of the company as it expands and builds. In an all-cash deal, the seller walks away, often from a company they have devoted years to building. While equity does allow them to continue to benefit from the company's growth, it is important to understand that it also means continuing to share any risks.

The seller also has a large tax benefit when more stock is involved. Cash offerings trigger a tax event for the seller, but stock can lessen the tax burden if issued in sufficient amounts. The greater amount of stock offered, the less tax liability as it often allows for deferred payments.

Sellers must be aware that they are assuming the risk that their shares could drop before the deal closes, and they could see their value decrease, particularly in today's environment. This is especially important if the deal is structured as a fixed exchange ratio. Sellers also need to conduct even greater due diligence with mixed offerings, as they will need to look more closely into the buyer than with an all-cash offer.

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Mixed offerings will likely become an even larger percentage of M&A transactions as interest rates continue to rise, and the stock portion of those offerings could also become larger. That means it is increasingly essential for both buyers and sellers to understand both risks and rewards and take all of those into consideration when structuring the deal.

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