INTEGER WEALTH GLOBAL

Literature – Proof of Funds

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Proof of Funds (POF) refers to documentation typically in the form of a letter confirming that a buyer has sufficient funds to complete a proposed transaction.
Proof of funds usually comes in the form of a bank, security, or custody statement. The purpose of the proof of funds document is to ensure that the funds needed to execute the transaction fully are accessible and legitimate.

1. Proof of Funds Letter in Real Estate (Home Mortgage)

The proof of funds document verifies the legitimacy of a purchase offer by demonstrating that the potential buyer has sufficient funds to execute the deal.

As a simple example, let’s imagine that you’re purchasing a home and need to obtain a mortgage.

Upon expressing your interest in buying the home, the subsequent step is to provide certain documentation requested by the seller.

Sellers often request a POF letter to ensure the buyer has enough cash available to cover the purchase costs of the home, which can include:

- Down Payment
- Escrow
- Closing Costs

Unless the buyer can prove it has adequate cash, the seller is unlikely to proceed with the sale process.

Here, the buyer would likely share documentation such as:

- Recent Bank Statements
- Letter of Recommendation from Previous Landlords
- Signed Letter from Bank on Liquid Funds Available
- Background Check from Credit Agency

The buyer’s credibility can be assessed by the seller using these documents to eventually determine if the purchase offer is viable.

2. Proof of Funds Letter in M&A Financing

In the context of M&A transactions, proof of funds is conceptually similar but are usually much more complex with more moving pieces and contributors to the end document.

When purchasing a home, a POF letter can be as simple as a bank statement showing the buyer's account balance. However, in M&A deals where entire companies are purchased, funding often comes from third-party lenders of debt financing, investment funds, banks or investment management companies.

Hence, this process is much more formalized and time-consuming compared to simpler residential real estate deals (e.g., single-family homes, multi-family homes).

In practically all M&A transactions, there will be an investment bank providing advisory services to the seller – which is called sell-side M&A.

Moreover, upon compiling a buyer list (i.e. the potential acquirers that have expressed interest in participating in the sale process), the investment bank is also responsible for vetting each buyer's profile, namely its ability to pay.

Similar to the seller of a home, the investment bank seeks to trim the list and filter out any buyers with:

- Inadequate Funding (e.g., Minimal Deployable Capital)
- Bad Creditability (i.e., History of Incomplete Deals)
- No Tangible Progress in Proof of Financing (e.g., Commitment Letters)

3. Causes of Failed M&A Deals: Commitment Letter

On the sell-side, the offer price is one of the main considerations as the process commences usually over several months, however, an offer must be backed by documents proving the bid amount can actually be financed.

Otherwise, the seller might receive an offer (i.e., valuation) that prioritises that buyer, only to later find out that the buyer does not have enough capital to complete the deal. The valuation may also increase or decrease and so the document should compensate for such effect.

In the meantime, other more serious bidders may be neglected due to lower offer prices and may even be removed from the process entirely.

Therefore, to prevent such circumstances that would lead to a 'broken deal', M&A advisors request documentation from all buyers on how they intend to fund the transaction, such as:

- Financial Statements – i.e., Cash Balance in Bank
- Commitment Letter from Lenders
- Appraisals from Independent Accountants and/or Valuation Firms
- Risk management structures for pre and post transaction
- Legal requirements and constraints
- Regulatory requirements and constraints should an investment or other backer be involved.
- Bank KYB and KYC processes
- Acquisition scoring through an independent risk assessor i.e., Standard & Poors, Moody's Fitch or Dunn & Bradstreet or Integer Wealth Global Professional Services.

Failed M&A transactions can be attributable to a lack of buyer interest in the market, among other factors as also one, several or all of the omission or non-compliance with the above list.

Yet one major sell-side risk to look out for is bids from buyers with inadequate funding sources (e.g., cash, equity, debt).

4. Proof of Funds Letter (POF) and Buyer Profile

Financial Buyer vs. Strategic Buyer in M&A

When financing acquisitions, proof of fund letters (POF) pertain more to financial buyers due to their increased reliance on debt.

- **Financial Buyer**: For example, a private equity firm could fund a leveraged buyout (LBO) with 50% to 75% of the purchase price comprised of debt – and the remainder coming from an equity contribution which consists of capital raised from its limited partners (LPs).
- **Strategic Buyer**: By contrast, a strategic buyer (i.e. a competitor) is more likely to fund the transaction using cash sitting on its balance sheet.

In-depth due diligence to verify that the interested buyer has enough funds to complete the purchase is thus more important when more of the purchase consideration is composed of debt.

While the current cash balance of a buyer can be relatively easily checked, their ability to receive future debt financing is not as straightforward to verify.

With this consideration, a transaction contingent on the buyer receiving financing commitments from lenders is a risk that M&A advisors attempt to mitigate.

5. Proof of Funds Letters (POF) and Escrow Accounts

If debt represents a significant component of the funding structure, financing commitments from lenders play an integral role in developing legitimacy as a prospective buyer.

The buyer must receive a commitment letter from a lender stating that a certain amount of financing will be provided to the buyer to fund the deal.

But the negotiation process tends to lengthen the larger the financing package is, as well as the credit risk of the borrower.

In addition, another factors to consider is escrow accounts in M&A.

Escrow accounts are frequently set up in M&A as a preventive risk measure in case there was a breach of the purchase agreement or other undisclosed material issues (i.e. "bad faith").

Thus, to ensure there are mechanisms in place in case of a potential breach (and/or purchase price adjustment), escrow funds can be agreed upon for the following benefits:

- **Seller's Benefit** – The buyer is likely more willing to offer higher purchase prices given that there is money in an escrow account in case any issues arise that lower the value of the company post-deal.
- **Buyer's Benefit** – If the seller breached a contractual provision (e.g., overstated value of assets/revenue sources, hidden liabilities/risks), then the buyer can receive some capital as negotiated in the contract.

For all transactions – whether it be real estate or M&A – one of the primary seller considerations is the certainty of closure, which the buyer aims to bolster with the proof of funds.

6. Uses of Proof of Funds Documentation

Some of the more common situations may include but are not limited to:

- **Real Estate Transactions:** To verify that the buyer has the money to finish the transaction, sellers or their representatives frequently demand proof of funds documentation.
- **Investment Opportunities:** Proof of funds may be required to verify the investor's financial capacity when investing in specific opportunities such as private placements or business purchases.
- **Loan Applications:** To determine a borrower's capacity to make down payments or pay closing expenses, lenders may ask for proof of money.
- **Immigration Applications:** Immigration authorities may ask applicants to provide proof of their financial ability to sustain themselves during their stay or while settling in a new country.
- **Business Transactions:** In order to confirm the financial competence of the parties involved in mergers, acquisitions, or partnerships, proof of funds documentation may be needed.
- **Creating a Trust:** Establishing a trust account may require providing proof of funds to show the initial funding or continuous financial capability to operate the trust.
- **Contract Bidding:** When taking part in contract bidding procedures, especially for government or large-scale projects, proof of funds may be needed to show the financial capacity to meet the criteria of the contract.
- **Private Sales:** In private sales or high-value transactions, sellers may ask for proof of funds to make sure the buyer has the money needed to complete the transaction. This may relate to industries above (i.e. real estate) or in other high-value industries such as art or collectibles.
- **Business Licensing:** To ensure financial viability and compliance with regulatory criteria, proof of cash may be required when applying for various business licenses or permits.
- **Franchise Opportunities:** When considering purchasing a franchise, proof of funds may be required to demonstrate financial capability and suitability as a franchisee.
- **Auction Participation:** Proof of funds may be necessary when participating in auctions to show the ability to meet bidding requirements or payment obligations.
- **Escrow Transactions:** Proof of funds may be requested when entering into escrow agreements to ensure that the necessary funds are available for the agreed-upon transaction.

7. How Recent Should the Proof of Funds Document Be.?

The freshness requirement for proof of funds documents can vary, but generally documents no older than 90 days are considered acceptable. Be mindful that certain circumstances may call for documents no older than 30 days. For example, when closing on a mortgage, your mortgage lender will often require proof of funds documentation from the most recent month available.

8. Are Digital or Scanned Copies of Proof of Funds Documents acceptable.?

In many cases, digital or scanned copies of proof of funds documents are acceptable, as long as they are clear and legible. However, it is advisable to verify the specific requirements of the involved parties or institutions.

9. What Formatting Requirements are required for a 'Proof of Funds' Document.?

While formatting requirements may vary, the document should clearly display necessary information such as the account holder's name, account number, financial institution details, and the available balance. In addition to substantiating the financial information, the user of the proof of funds documentation will want sufficient evidence that you are the owner of the account.

10. What Types of Documents Can Be Used As Proof of Funds.?

Common types of proof of funds documents include bank statements, investment account statements, balance certificates issued by financial institutions, confirmation documents, letters and certificates from investment funds, investment companies, solicitors and letters from financial institutions confirming the availability of funds.

11. Key Considerations

- Proof of funds refers to a document that demonstrates the ability of an individual or entity to pay for a specific transaction.
- A bank statement, security statement, or custody statement usually qualify as proof of funds.
- Proof of funds is typically required for a large transaction, such as the purchase of a house.
- Basic information, such as the bank name and address, bank statement, total balance amounts, a bank personnel's signature, is required on the proof of funds document.
- Proof of funds and proof of deposit are often both needed when applying for a mortgage.