# Chapter 44
# LBOs

*Use management as a lever and lean on it!*

Leveraged buy-outs (LBOs) are a form of corporate acquisition. Equity capital is reduced by the increase of financial leverage. There is usually a concomitant change in control. This technique is very popular in English-speaking countries and has recently found favour in continental Europe as well.

Why are financial investors willing to pay more for a company than a trade buyer investor? Are they miracle workers? Watch out for smoke and mirrors. Val ue is not always created where you think it will be.

In the course of this chapter we will use the leveraged buy-out of Weetabix, bought by Hicks, Muse, Tate & Furst, as an example[1].

## Section 1
## LBO structures

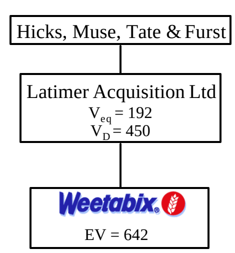
### 1/ Principle

The basic principle is to create a holding company, the sole purpose of which is to hold financial securities. The holding company borrows money to buy another company, often called the "target". The holding company will pay interest on its debt and pay back the principal from the cash flows generated by the target. In LBO jargon, the holding company is often called *NewCo* or *HoldCo*.

Operating assets are the same after the transaction as they were before it. Only the financial structure of the group changes. Equity capital is sharply reduced and the previous shareholders sell part or all of their holding.

From a strict accounting point of view, this set-up makes it possible to benefit from the effect of financial gearing (see chapter 13).

Obtaining tax consolidation between the holding company and the target is one of the drivers of the overall structure.




[1] We have based this example on publicly available information, and have for some of the figures either simplified the reality or made some estimates. It should be considered as illustrative and does not intend to reflect the reality or the exact state of the company.

Now let us take a look at the example of Weetabix, sold in November 2003 by Sir Richard George and Weetabix' other minority shareholders for £642m (we will assume for illustrative purposes that this represents the value of equity and the enterprise value, in fact Weetabix had cash on its balance sheet at the time of the acquisition). Weetabix generated annual operating profit of £44m.

A holding company is created and buys Weetabix, financing the purchase with £192m in equity and £450m in debt.

*•CHART 44-1•*

We assume that the pre-tax cost of debt is 7.5% (5% plus a 2.5% margin). The balance sheets are as follows:

| Target's revalued balance sheet | | Holding company's unconsolidated balance sheet | | Group's consolidated balance sheet | |
|---|---|---|---|---|---|
| Assets £642m | Shareholders' equity £642m | Shares of target company £642m | Debt £450m | Assets £642m | Debt £450m |
| | | | Shareholders' equity £192m | | Shareholders' equity £192m |

Note that consolidated shareholders' equity, on a revalued basis, is now 65% lower than it was prior to the LBO.

The profit and loss statement, meanwhile, is as follows:

| in € m | Weetabix | Holding company | Consolidated |
|---|---|---|---|
| Earnings before interest and tax | 44 | 31 (1) | 44 |
| – Interest expense | 0 | -34 | -34 |
| – Income tax at 30% | -13 | 0 (2) | -3 (3) |
| = Normalised net income | 31 | (3) | 7 |

(1) Assuming 100% pay-out
(2) The holding company benefits from tax exemption.
(3) Assuming tax consolidation treatment.

## 2/ Types of LBO transactions

***Leveraged Buy-out*** or ***LBO*** is the term for a variety of transactions in which an external financial investor uses leverage to purchase a company. Depending on how management is included in the takeover arrangements, LBOs fall into the following categories:

• a ***(Leveraged) Management Buy-Out*** or ***(L)MBO***, is a transaction undertaken by the existing management together with some or all of the company's employees;

• when outside managers are brought in, the transaction is called a ***BIMBO***, i.e. a combination of a *buy-in* and a *management buy-out*. This is the most common type of LBO in the UK;

• finally, the term ***Leveraged Build-Up (LBU)*** is used to describe a LBO in which the new group continues to acquire companies in its sector so as to create industrial synergies. These acquisitions are financed primarily with debt.

## 3/ Exit strategies

The average LBO lifetime is becoming shorter and shorter. Financial investors now generally keep the investment for three to five years. There are several exit strategies:

- sale to a trade buyer. Our general comment here is that in most cases financial investors bought the company because it had not attracted trade buyers. When time for the exit of the financial buyer has arrived, either the market or the company will have had to change for a trade buyer to be interested;
- stock market flotation. This strategy must be implemented in stages, and it does not allow the sellers to obtain a control premium. It is more attractive for senior management;
- sale to another financial investor, who in turn sets up another LBO. These "secondary" LBOs are becoming more and more common.

If the company has grown or become more profitable on the financial investors' watch, it will be easier for them to exit. Improvement may take the form of a successful redundancy or cost-cutting plan or a series of bolt-on acquisitions in the sector. Size is important if flotation is the goal, because small companies are often undervalued on the stock market, if they manage to get listed at all.

The problem emerges when the target company's profits do not allow a large enough dividend payment to the parent company, which is then unable to pay its bank interest charges or repay in a timely fashion its debt. Apart from recapitalising the company, several options exist, two of which are not very viable:

- borrow at the subsidiary level, and lend to the parent company. This would constitute an intra-group transfer for purely financial reasons and could be challenged depending on the national corporate law as misuse of corporate property;
- merge the two entities;

Renegotiate with creditors is the traditional solution, but in some countries the creditors cannot secure their loans with the assets of the subsidiary so long as the loans are extended to the holding company.

# Section 2
# The players

## 1/ Potential targets

The transactions we have just examined are feasible only with certain types of target companies. Companies for which income streams are volatile by nature, such as trading companies, do not have access to LBO financing. The same is true for companies requiring heavy capital expenditure, such as certain high-tech companies.

The target company must generate profits and cash flows that are sufficiently large and stable over time to meet the holding company's interest and debt payments. The target must not have burdensome investment needs. Mature companies that are relatively shielded from variations in the business cycle make the best candidates: food, retail, building materials, real estate, cinema theatres, yellow pages are all prime canididates.

The group's LBO financing already packs a hefty financial risk, so the industrial risks had better be limited. Targets are usually drawn from sectors with high barriers to entry and minimal substitution risk. Targets are often positioned on niche markets and control a significant portion of them.

Traditionally, LBO targets are "cash cows", but more recently, there has been a movement towards companies exhibiting higher growth or operating in sectors with opportunities for consolidation.

## 2/ The sellers

Around half of all LBOs are carried out on family-owned companies. An LBO solves the succession problem. In 40% of cases, a large group wishing to refocus on a core business sells a subsidiary or a division via an LBO. The larger transactions fall into the latter category (Houghton Mifflin sold by Vivendi Universal, Provimi sold by Edison, Seat PG by Telecom Italia).

Finally, some listed companies that are undervalued (often because of liquidity issues or because of lack attention from the investment community because of their size), sometimes opt for "**public-to-private**" (**P to P**) LBOs. In the process, the company is delisted from the stock exchange. Despite the fact that these transactions are complex to structure and generate high execution risk they are becoming more and more common thanks to the drop in market values. The LBO on the Irish packaging group Jefferson Smurfit in 2002 has been one of the largest European P to P (€ 5.6 bn in enterprise value).

## 3/ LBO funds are the equity investors

Setting up an LBO requires specific expertise, and certain investment funds specialise in them. These are called *private equity sponsors*, because they invest in the equity capital of unlisted companies or *venture capitalists*, because they venture into risky territory!

LBOs are particularly risky because of their high gearing. Investors will therefore undoubtedly require high returns. Indeed, required returns are often in the region of 25% p.a. In addition, in order to eliminate diversifiable risk, these specialised investment funds often invest in several LBOs.

The US and UK LBO markets are more mature than those of continental Europe. For this reason, Anglo-Saxon funds such as BC Partners, Candover, Carlyle, Cinven, CVC, Hicks Muse and KKR dominate the market, particularly when it comes to large transactions. In the meantime, the purely European funds, such as Eurazeo, Industrie Kapital and PAI are holding their own, generally specialising in certain sectors or geographic areas.

To reduce their risk, LBO funds also invest alongside another LBO fund or an industrial company (sometimes the seller) with a minority stake. In this case, the industrial company contributes its knowledge of the business and the LBO fund its expertise in financial engineering, the legal framework and taxation.

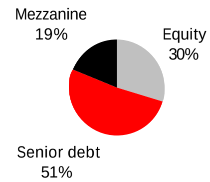
## 4/ The lenders

For smaller transactions (less than €10m), there is a single bank lender, often the target company's main bank.

For larger transactions, debt financing is more complex. The high degree of financial gearing requires not only traditional bank financing, but also subordinated lending and **mezzanine debt**, which lie between traditional financing and shareholders' equity. This results in a four-tier structure: traditional, secured loans called **senior debt**, to be repaid first, **subordinated** or **junior debt** to be repaid after the senior debt, mezzanine financing, the repayment of which is subordinated to the repayment of the junior and senior debt, and last in line, shareholders' equity.

These borrowings can be complemented by seller financing, wherein the seller of the target company does not receive full payment immediately, and by securitisation[1].

**LBO financing example: Weetabix**




•CHART 44-2•

**Senior debt**

Senior debt generally totals four to five times the target's EBITDA. It is composed of several tranches, from least to most risky:

- tranche A is repaid in equal instalments over three to five years;
- tranches B and C are repaid over a longer period (five to seven years) after the A tranche has been amortized.

(1) 100 basis points = 1%

Each tranche has a specific interest rate, depending on its characteristics (tranche B and C will be more expensive than trance A because they are repaid after and are therefore more risky). The cost of senior LBO financing is 200 to 300 basis points(1) over government bond yields.

When the debt amount is high, the loan will be "syndicated" to several banks (see Chapter 27). Some banks have launched "collateralised debt obligation" (CDO) funds, specialised in senior LBO financing.

**Junior or Subordinated bonds**

High-yield bond issues are sometimes used to finance LBOs, but this technique is reserved for the largest transactions so as to ensure sufficient liquidity. In practice the lower limit is around €100m.

An advantage of this type of financing is that it carries a bullet repayment and a maturity of eight to ten years. In accordance with the principle of subordination, the bonds are repaid only after the senior debt is repaid.

Given the associated risk, high-yield LBO debt offers investors, as the name suggests, high interest rates. They can be as much as 800 basis points over government bond yields.

**Mezzanine debt**

Mezzanine debt also comes under the heading of (deeply) subordinated debt, but is unlisted and provided by specialised funds.

Returns on mezzanine debt take two forms: a relatively low interest rate and a share in any capital gain when the LBO fund sells its stake.

As we saw in chapter 30, certain instruments accommodate this financing need admirably. These "hybrid" securities include convertible bonds, mandatory convertibles, warrants, bonds with warrants attached, etc.

Most of the time, mezzanine debt is made of bullet bonds[1] with warrants attached.

[1] See page XXX

Mezzanine financing is a true mixture of debt and shareholders' equity. Indeed mezzaniners demand returns more akin to the realm of equity investors, often approaching 15% p.a.

Given the associated risk, investors in mezzanine debt – "mezzaniners" – demand not only a high return, but also a say in management. Accordingly, they are sometimes represented on the board of directors.

Subordinated and mezzanine debt offer the following advantages:

• They allow the company to lift gearing beyond the level acceptable for bank lending;

• They are longer term than traditional loans and a portion of the higher interest rate they are paid through a potential dilution. The holders of mezzanine debt often benefit from call options or warrants on the shares of the holding company;

• They make upstreaming of cash flow from the target company to the holding company more flexible. Mezzanine debt has its own specific terms for repayment, and often for interest payments as well. Payments to holders of mezzanine debt are subordinated to the payments on senior and junior debt;

• They make possible a financing structure that would be impossible by using only equity capital and senior debt.

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LBO financing spreads the risk of the project among several types of instruments, from the least risky (senior debt) to the most risky (common shares). The risk profile of each instrument corresponds to the preferences of a different type of investor.

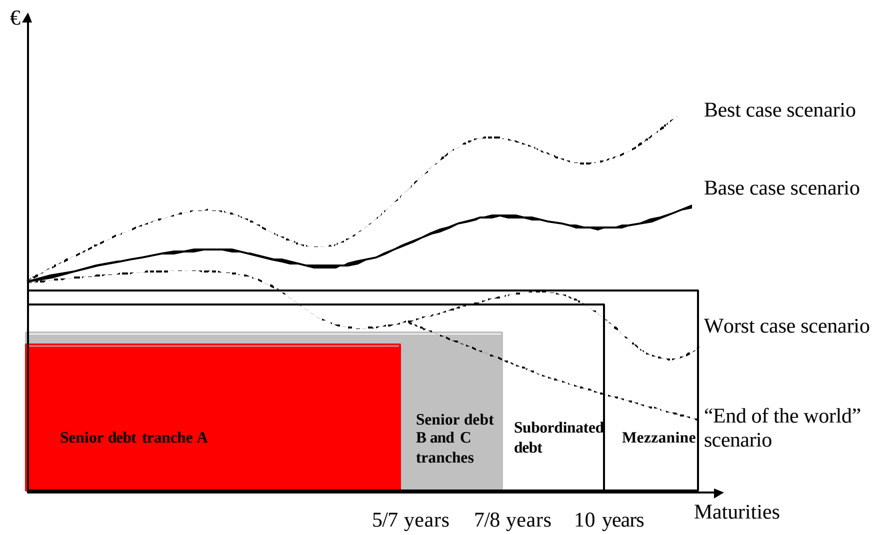


*CHART 44-3*

**Securitisation**

Increasingly, LBOs are partly financed by securitisation (see chapter 47). Securitised assets include receivables and/or inventories, when there is a secondary market for them.

A new technique, the securitisation buy-out, has arisen in the UK. It is similar to standard securitisation of receivables, but aims to securitise the cash flows from the entire operating cycle.

5/ European environment

In a survey led in 2004, the European Private Equity and Venture Capital Association (EVCA) benchmarked the European National tax and legal environments for financial buyers. The main issues covered in this study are:

? Fund structures and pension funds incentive to invest in private equity

? Merger regulation (private equity funds do not bear competition issues, therefore a specific simplified anti-trust clearance procedure should exist)

[1] See page XXX

- ? Company and capital gain tax rate
- ? Taxation of stock options
- ? Entrepreneurial environment
- ? Bankruptcy and insolvency

Based on these criteria, the scores of the different countries are the following (1 being the most attractive and 3 the least attractive):

| *Country* | *Score* | *Country* | *Score* |
|---|---|---|---|
| UK | 1.26 | France | 1.89 |
| Luxembourg | 1.49 | Spain | 1.96 |
| Ireland | 1.53 | **Total average** | **1.97** |
| Greece | 1.75 | Sweden | 2.05 |
| Netherlands | 1.76 | Czech Rep. | 2.12 |
| Portugal | 1.81 | Finland | 2.30 |
| Belgium | 1.82 | Germany | 2.37 |
| Italy | 1.86 | Austria | 2.42 |
| Hungary | 1.86 | Denmark | 2.46 |

*Source: EVCA*

The UK still represents the bulk of the LBO market with 686 transactions in 2003 compared to 563 for the rest of Europe! In value terms, the UK market accounted for € 23.5 bn compared to € 39.7 bn for the rest of Europe. Larger transactions are becoming more common outside the UK (Legrand for € 4.9 bn, Jefferson Smurfit for € 3.2 bn, Seat PG for € 5.65 bn …)

## Section 3
## LBOs and financial theory

LBOs have gained considerable popularity since the mid-1980s, even though the market is cyclical and experienced a dry spell in the early 1990s.

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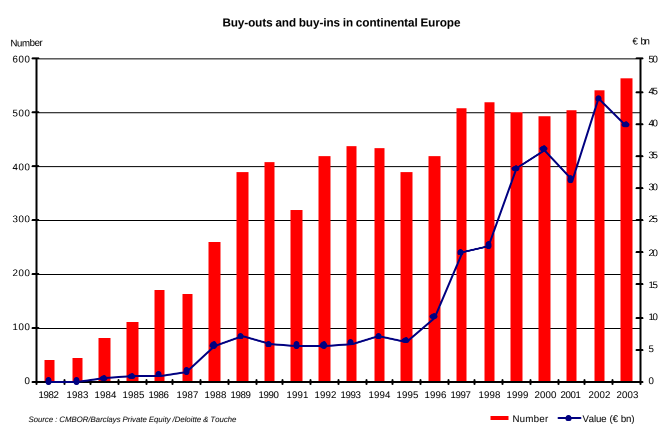


•*CHART 44-4*

Experience has shown that LBOs are often done at the same price or at an even higher price than the price a trade buyer would be willing to pay. Yet the trade buyer, assuming he plans to unlock industrial and commercial synergies, should be willing to pay more. How can we explain the widespread success of LBOs? Do they create value? How can we explain the difference between the pre-LBO value and the LBO purchase price?

At first, we might be tempted to think that there is value created because increased leverage reduces tax payments. But the efficient markets hypothesis casts serious doubts on this explanation, even though financial markets are not in reality always perfect. To begin with, the present value of the tax savings generated by the new debt service must be reduced by the present value of bankruptcy costs. Secondly, the arguments in chapter 34 have led us to believe that the savings might not be so great after all. Hence, the attractions of leverage are not enough to explain the success of the LBO.

We might also think that a new, more dynamic management team will not hesitate to restructure the company to achieve productivity gains and that this would justify the premium. But this would not be consistent with the fact that the LBOs that keep the existing management team create as much value as the others.

Agency theory provides a credible explanation. The high debt level prompts shareholders to keep a close eye on management. Shareholders will closely monitor operating performance and require monthly in-depth reporting. Management is put under pressure by the threat of bankruptcy if the company does not generate enough cash flow to rapidly pay down debt. At the same time, the managers often become – either directly or potentially – shareholders themselves via their stock options, so they have incentive to manage the company to the best of their ability.

Management, motivated by a potentially big pay-off and frightened by a heavy debt burden, will manage the company in the most efficient manner possible, increasing cash flows and hence the value of the company. It's the carrot-and-stick approach!

S. Kaplan has demonstrated through the study of many LBOs that their operating performance compared with that of peer companies are much better. This is one example where there is a clear interference of financial structure with operating performance.

LBO transactions greatly reduce agency problems and in so doing, create value.

However, LBOs that allow the former managers to "liquidate" the majority of their holdings and invest only a small portion as part of a core group of shareholders while remaining in their management positions are particularly dangerous. Management's motivation in these cases is not increased, but on the contrary, significantly decreasing!

## Summary

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A leveraged buy-out is a transaction wherein the purchase of a company is financed primarily with borrowed funds. A holding company contracts the debt and purchases the target company. The company's cash flow is regularly funnelled upstream to the holding company via dividends to enable the latter to pay interest and reimburse the loans.

An LBO is often a solution in a family succession situation or when a large group wants to sell off a division. It can also be a way for a company to delist itself when it is undervalued in the market.

The target company in an LBO may keep the current management in place or hire a new management team. Equity capital is provided by specialised funds. The structure depends on several layers of debt –senior, junior, mezzanine – with different repayment priority. As priority declines, risk and expected returns increase.

Increased gearing and the deductibility of interest expense do not satisfactorily explain why value is created in an LBO. Instead, it appears that the heavier debt burden motivates management to do a better job managing the company, of which they are often destined to become shareholders themselves. This is agency theory in action.

## Questions

@ quiz

1/ Explain why an LBO is a type of capital reduction.

2/ What risks are involved in an LBO?

3/ Can mezzanine financing in the context of an LBO be compared with equity or debt?

4/ In the context of an LBO, does the holder of senior debt take more or less risk than the holder of junior debt?

5/ Can an LBO be carried out on an Internet company?

6/ Can an LBO be carried out on a cereals trader?

## Answers

### Questions

1. Because debt is replaced with shareholders' equity.
2. The risk that debts will outweigh cash flows generated.
3. With debt because sooner or later it has to be repaid.
4. Less risk b ecause the holder of senior debt is repaid before the holder of junior debt.
5. No, because an Internet company's cash flows are much too volatile to allow it to carry debt.
6. No, because a cereal trader's cash flow is much too volatile to allow it to c arry high fixed financial costs.

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