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   RESULTS & DISCUSSION

   FINDINGS

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- Schemenner, R.W., Huber, J.C. and Cook, R.L. (1987), "Geographic Differences and the Location of New Manufacturing Facilities," Journal of Urban Economics, Vol. 21, No. 1, pp. 83-104.

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# A STUDY ON VALUE GENERATION IN LEVERAGED BUTOUT'S

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## ABSTRACT

*Leveraged Buyout's (LBO) have become very attractive as they usually represent a win-win situation for the financial sponsor and the banks. The financial sponsor can increase the returns on his equity by employing the leverage; banks can make substantially higher margins when supporting the financing of LBOs as compared to usual corporate lending, because the interest chargeable is that much higher. A leveraged buyout (LBO) is an acquisition of a company or a segment of a company funded mostly with debt. A financial buyer (e.g. private equity fund) invests a small amount of equity (relative to the total purchase price) and uses leverage (debt or other non-equity sources of financing) to fund the remainder of the consideration paid to the seller. The LBO analysis generally provides a "floor" valuation for the company, and is useful in determining what a financial sponsor can afford to pay for the target and still realize an adequate return on its investment.*

## KEYWORDS

Consideration, Leverage, Return on investment, Valuation.

## INTRODUCTION

A leveraged buyout is a financing technique in which the acquisition is substantially financed through debt & **involves converting public company to private**. Debt typically forms 50% or more of the purchase price. The consideration for LBO is a mix of debt & equity components with higher gearing. Debt is obtained on the basis of company's future earnings potential. Much of the debt may be secured by the assets of the acquired company (Asset based lending). Internal cashflows & sale of assets are used to repay the original owners of LBO. LBO mechanism allows new breed of entrepreneurs the opportunity to create wealth.

Leveraged Buyout (Highly –Leveraged Transaction (HLT), or "bootstrap" transaction means mobilizing borrowed funds based on the security of assets and cash outflows of the target company (before its takeover) and using those funds to acquire the target company. A leveraged buyout (LBO) is when a company or single asset (e.g., a real estate property) is purchased with a combination of equity, plus, significant amounts of borrowed money – structured in such a way that the target's cash flows or assets are used as the collateral (or, "leverage") to secure and repay the money borrowed to purchase the target-company/asset. As financial sponsors increase their returns by employing a very high leverage (i.e., a high ratio of debt to equity), they have an incentive to employ as much debt as possible to finance an acquisition. This has in many cases led to situations, in which companies were "over levered"

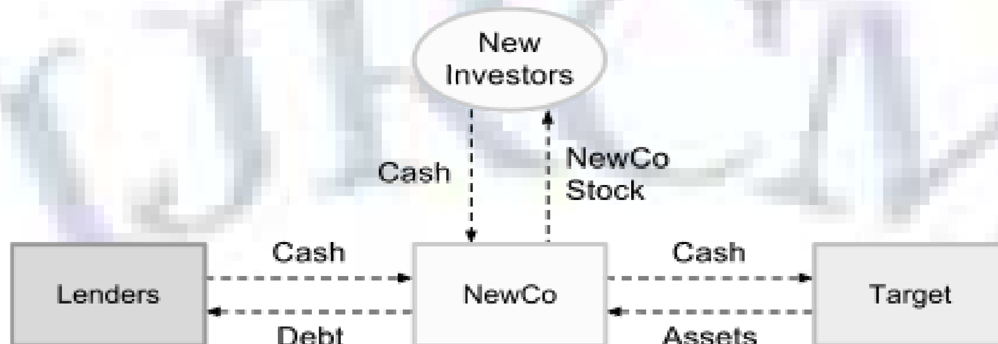
A company for acquisition via LBO should possess the following attributes:

- It must have a good position in the industry with sound profit history.
- It should have a relatively low level of debt and high level of "bankable" assets.
- It must have stable and predictable cash flows that are adequate to meet interest and principal payments on the debt and provide adequate working capital.

## CHARACTERISTICS OF LBO

1. **Stable cash flows:** One of the very important features of LBO candidate is the presence of stable cash flows. Greater the variability of historical cash flows, higher will be the risk to the lender. High variability of cash flows can worry the lender.
2. **Stable and experienced management:** Lenders feel secured when the existing management is experienced and stable.
3. **Room for significant cost savings:** As the debt content is huge, lenders will look for significant cost savings after the LBO is through. This will help the company to reduce the costs and improve its debt servicing capacity.
4. **Equity investment of managers:** Equity investment of managers and outsiders acts as a cushion to protect lenders. Higher the equity, greater the security to the lenders.
5. **Ability to cut cost:** There should be significant areas where the cost can be cut without damaging the business of the division.
6. **Separable non-core business:** If the LBO candidate owns non-core business, it can be sold-off quickly to reduce the debt of the division.

## TRANSACTION STRUCTURE OF LBO




The amounts of debt banks are willing to provide to support an LBO depends on:

- The quality of the asset to be acquired (stability of cash flows, history, growth prospects, hard assets)
- The amount of equity supplied by the financial sponsor
- The history and experience of the financial sponsor
- The economic environment

Depending on the size and purchase price of the acquisition, the debt is provided in different tranches.

- **Senior debt:** This debt is secured with the assets of the target company and has the lowest interest margins
- **Junior debt (usually mezzanine)**: This debt usually has no securities and bears thus a higher interest margins

In larger transactions, debt is often syndicated, meaning that the bank who arranges the credit sells all or part of the debt in pieces to other banks in an attempt to diversify and hence reduce its risk. Another form of debt that is used in LBOs is seller notes (or vendor loans) in which the seller effectively uses parts of the proceeds of the sale to grant a loan to the purchaser. Such seller notes are often employed in management buyouts or in situations with very restrictive bank financing environments. Note that in close to all cases of LBOs, the only securities available for the debt are the assets and cash flows of the company. As a rule of thumb, senior debt usually has interest margins of 3–5% and needs to be paid back over a period of 5–7 years, junior debt has margins of 7–16%, and needs to be paid back in one payment (as bullet) after 7–10 years.

## ISSUES THAT ARE CONSIDERED IN AN LBO TRANSACTION

**INDUSTRY CHARACTERISTICS**

- Type of industry
- Competitive landscape
- Cyclicality
- Major industry drivers
- Potential outside factors (politics, changing laws and regulations, etc.)

**COMPANY-SPECIFIC CHARACTERISTICS**

- Strategic positioning within the industry (market share)
- Growth opportunity
- Operating leverage
- Sustainability of operating margins
- Potential for margin improvement
- Level of maintenance CapEx vs. growth CapEx
- Working capital requirements
- Minimum cash required to run the business
- Ability of management to operate effectively in a highly levered situation

**MARKET CONDITIONS**

- Accessibility and cost of bank and high yield debt
- Expected equity returns

## STAGES/ELEMENTS OF LBO OPERATION

**1ST STAGE – ARRANGEMENT OF FINANCE**

- The first stage of the operation consists of raising the cash required for the buyouts and working out a management incentive system.
- Usually around 10% of cash put up by the company's top management &/or the buyout specialists. Management share around 30% of the equity share in the LBO. Outside investors like merchant bankers, venture capitalists and commercial banks then arrange to provide the remaining equity.
- Usually, 50% to 60% of the required cash is raised by borrowings against company's assets in secured bank acquisition loans from commercial banks. This portion of the debt is sometimes also taken from insurance companies, pension funds or from limited partnerships specializing in venture capital investments.
- Rest of the cash is obtained by issuing certain debts in a private placement, usually with Pension funds, Insurance companies, Venture capital firms or Public offerings through high-risk high-yield junk bonds.

**2ND STAGE – TAKING PRIVATE**

- This stage involves making the firm private. The company can be made private either in a stock purchase format where all the shares of the company are purchased or in an asset purchase format where all the assets are the company is purchased.
- In an asset purchase format the buying group forms new privately held corporations. Some of the parts of the business are sold off by the new management to reduce the debt.

**3RD STAGE – RESTRUCTURING**

- In this stage, the new management would try to increase the profits and cash flows by reducing certain operating costs and changing the marketing strategy. For this operation, it may adopt any of the given policies,
  - It may strengthen & restructure production facilities.
  - Change product quality.
  - Alter product mix.
  - Improved customer service.
  - Improve inventory control & accounts receivables management.
  - Trimming employment through attrition.
  - Reduce the expenditure on research & development as long as these are necessary to meet the payment on the huge borrowings.

**4TH STAGE – REVERSE LBO**

- Under this stage, the investor group may take the company to public again. If the restructured company has become stronger and the goals set by the LBO groups have already been achieved.
- This is known as the process of 'Reverse LBO' or the process of 'Going Public', where the process is affected through public offerings. The sole purpose of this exercise is to create liquidity for existing shareholders.

**RETURNS**

In LBO transactions, financial buyers seek to generate high returns on the equity investments and use financial leverage (debt) to increase these potential returns. Financial buyers evaluate investment opportunities with by analysing expected *internal rates of return* (IRRs), which measure returns on invested equity. IRRs represent the discount rate at which the net present value of cash flows equals zero. Sponsors also measure the success of an LBO investment using metric called "cash-on-cash" (CoC). CoC is calculated as the final value of the equity investment at exit divided by the initial equity investment, and is expressed as a multiple.

**RISK**

<u>Equity holders</u> – In addition to the operating risk assumed risk arises due to significant financial leverage. Interest costs resulting from substantial amounts of debt are "fixed costs" that can force a company into default if not paid. Furthermore, small changes in the enterprise value (EV) of a company can have a magnified effect on the equity value when the company is highly levered and the value of the debt remains constant.

<u>Debt holders</u> – The debt holders bear the risk of default equated with higher leverage as well, but since they have the most senior claims on the assets of the company, they are likely to realize a partial, if not full, return on their investments, even in bankruptcy.

<u>Candidates for LBO</u> - Usually, the candidates for implementation of an LBO strategy are the possible target firms threatened by takeover proposals from outside. The targets include the following:

1. If the company does not have share holdings more than 51%.
2. If the company is over leveraging with the debt components nearing to maturity.

3. If the company has diversified into unrelated areas and thus facing problems.
4. If the company is earning low operating profits due to poor management and there is a possibility of turn around.
5. If the company is having an asset structure which is grossly under utilized.
6. If the company's present management is facing managerial incompetence.

**LBO AND VALUE GENERATION**

Since the assumption clearly reflects the position of value creation through an LBO operation, one must identify the sources of value so generated. The sources are as follows:

Firstly reduction in agency cost is the most important source of value in an LBO.

- An LBO refers to take a public corporation to private. In case of pub. Corp., the mgt. is different from its owners.
- When public corp. goes private, the mgt. and the owners are the same and in all cases, the mgt. takes decisions which are not only cost effective, but also for the growth of the organization.
- An LBO exercise tries to eliminate the agency cost which is considered as a value gain for a restructured firm.

Secondly the source of value gain is associated with efficiency.

- It is argued that a private firm is much more efficient in taking decision in relation to changing environment than that of a public corporation, where every decision is not required to be ratified by the general body before implementation.
- It is this efficiency in decision-making which creates value for an LBO. Again production and portfolio efficiencies are perceived with an LBO operation because of the involvement of specialized LBO firms.
- Such efficiencies create benefits of synergy, which ultimately generate value.

Thirdly the source of value gain in case of an LBO is tax benefits as in such an operations, the source of leverage is debt and in this connection, the interest obligation of the private firm is exposed to certain tax benefits.

Finally, it is understood that management or investors in an LBO deal have more information on the value of the firm, than the ordinary shareholders. It is this information which adds value to an LBO and because of this value; the buy-out investors do not mind paying large premiums on such deals.

## ADVANTAGES OF LEVERAGED BUYOUT

- Flexible structure of financing
- Tax shield
- Discipline of debt helps leads to- divesting non-core business- cost cutting
- Synergy and efficiency gains

## DISADVANTAGES OF LEVERAGED BUYOUT

- Larger levels of debt-increased risk
- Too high a price asked for by a seller
- Layoffs increase
- Long-term growth disrupted as company focuses on short term goal of reducing debt at the cost of R&D
- Dilution in equity and increase in number of owners raises conflict in management.

## FACTORS AFFECTING PRE-BUYOUT RETURNS

- Premium paid to target firm shareholders frequently exceeds 40%
- These returns reflect the following (in descending order of importance):
  - Anticipated improvement in efficiency and tax benefits
  - Wealth transfer effects (e.g., from bondholders to shareholders)
  - Superior Knowledge
  - More efficient decision-making

## FACTORS DETERMINING POST-BUYOUT RETURNS

Empirical studies show investors earn abnormal post-buyout returns due to

- Full effect of increased operating efficiency not reflected in the pre-LBO premium.
- More professional management, tighter performance monitoring by owners, and reputation of financial sponsor.
- Studies may be subject to "selection or survival bias," i.e., only LBOs that are successful are able to undertake secondary public offerings.
- Abnormal returns may also reflect the acquisition of many LBOs 3 years after taken public.
- Properly timing when to exit the business.

## CONCLUSION

Despite of an LBO as an effective corporate restructuring mechanism to prevent hostile takeovers, the exercise is criticized on several other grounds. Because of heavy deployment of debts in financial restructuring, the cost of debt capital increases in the capital market, making difficult for other firms to raise debts for their needs. Many old and experienced employees of the target firm are threatened of loosing their jobs because of streamlining of the new management in the post-buyout scenario. Since the new mgt. in the post-buyout scenario concentrates on short-term goals like reduction of debt burden at the cost of research and development expenditure, the long term growth of the restructured firm is disrupted. In case of incapability of the restructured firm to redeem the debt, the firm is exposed to bankruptcy.

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