

Leveraged Buyouts: Course Notes

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Leveraged Buyouts

Leveraged Buyouts

An introduction to LBO deals



Leveraged Buyout (LBO) refers to a transaction in which a Special Purpose Vehicle (SPV) primarily funded through debt financing acquires a target company characterized by low debt levels and consistent cash flows.



What is an LBO?

Leveraged Buy-outs are deals, in which the acquirer of a firm uses a high portion of debt in order to finance the deal. The collateral for the debt that is being used are the target's cash flows. Lenders are willing to provide their funds because the target has a solid underlying business, which is expected to generate a stable stream of cash flows and hence they are likely to be repaid in full.

When is it feasible?

Mature companies are the ideal target for LBO transactions. They are well established in their market, and typically generate a solid stream of cash flows. There is little room for innovation in their business, so their cash needs are limited and predictable. It is reasonable to expect that the cash flows of the company can be used to reimburse the high leverage that is generated in an LBO transaction.

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70 – 75% of the deal is financed through debt and mezzanine loans. Financial sponsors can acquire large companies with a minimal investment by applying significant leverage



The amount of debt in an LBO

Financial sponsors are willing to take on board as much debt as possible. However, lenders need to know that there is enough equity that will protect their capital and decrease the overall risk of the transaction. For every firm we can measure a so-called maximum debt capacity, which is a function of the firm's cash flows and risk profile.

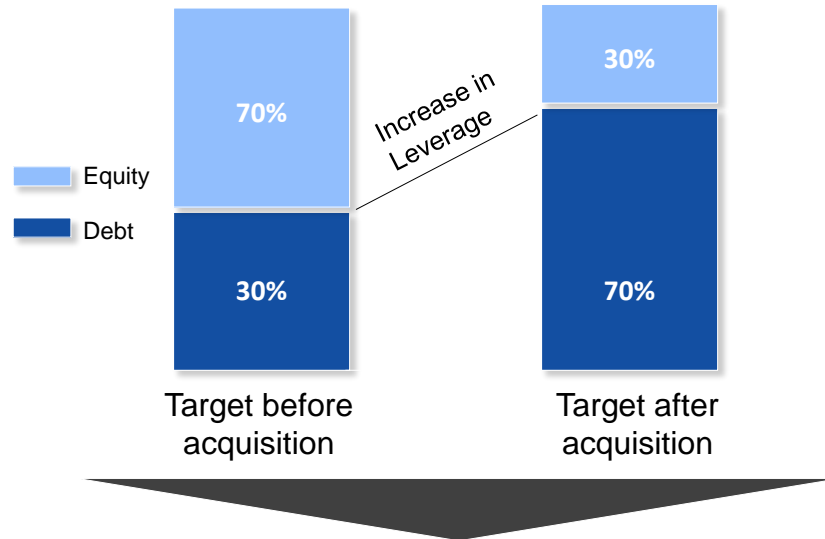
The lenders in an LBO

In general, LBOs are a risky business and lenders expect a good IRR. Senior lenders' remuneration will come from the spread on money market rates. They will take into consideration the initial debt drawdown amount, the holding period of the deal, the periodic interest rates to be received, and the principal repayment at closing. Mezzanine investors have a different risk profile. They make an initial contribution, receive periodic interest rates, a principal repayment at closing of the deal, and an equity kicker. The equity kicker allows mezzanine investors to acquire shares of the Target at a predetermined price upon exit, which ensures they participate in the upside from the deal.

The mechanics of an LBO transaction

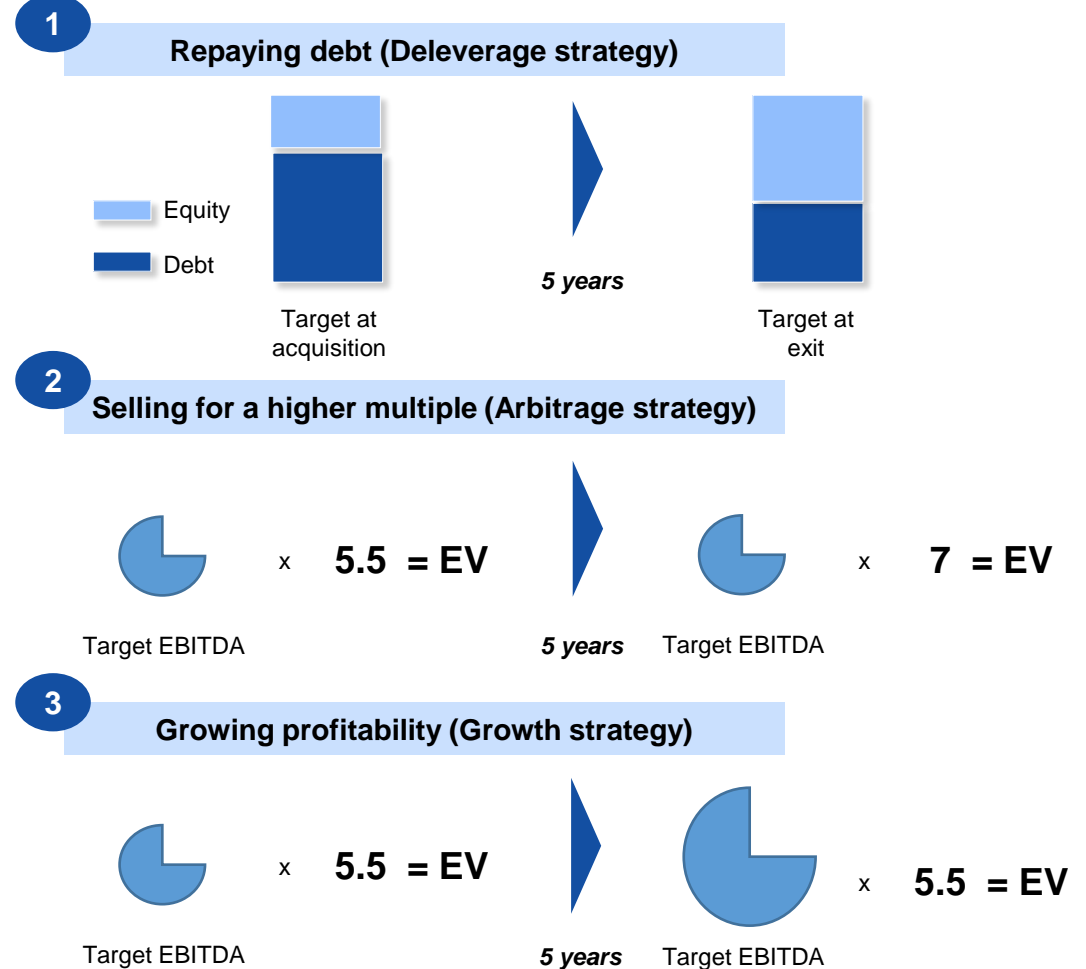
How does an LBO function and how come financial sponsors make so much money

How does an LBO function?



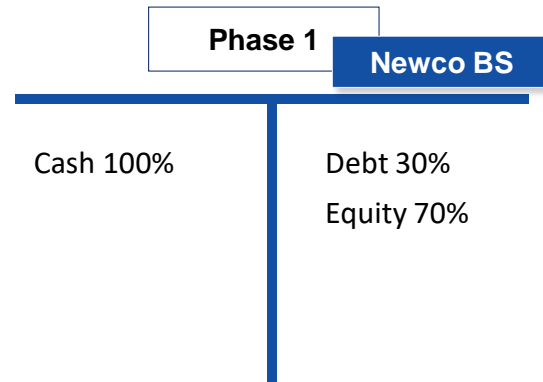
Leveraged Buyouts are deals, in which the acquirer of a firm uses a high portion of debt to finance the deal

How do financial sponsors make money in an LBO?

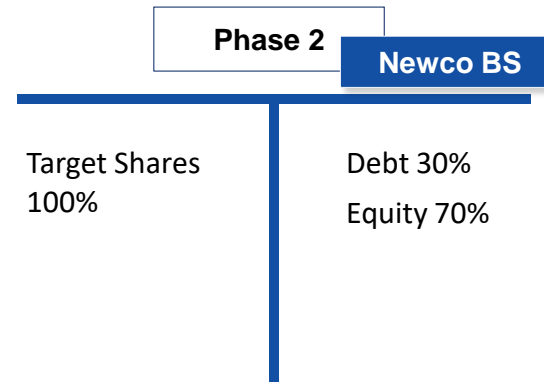


Finalizing the deal

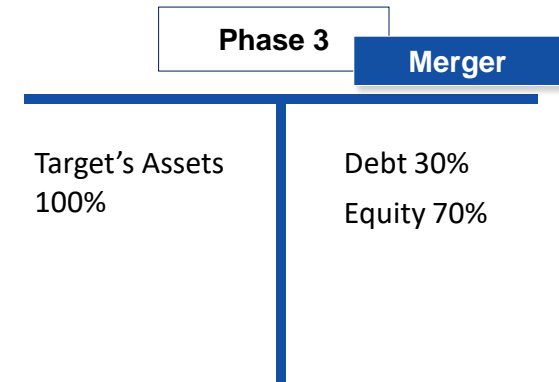
Completing an LBO deal in practice



Phase 1: Financial sponsors create a new company that has the cash necessary to complete the deal



Phase 2: The Newco acquires the Target's shares



Phase 3: The Newco and the Target are merged