Leverage Buy Out – LBO

INTRODUCTION

It refers to the acquisition of a company with a combination of debt and equity.

LBOs should be seen mainly as a financing technique : Debt is used to finance the acquisition, via an SPV (Special Purpose Vehicle), of an asset that generates cash flows.

In the case of the LBO, the asset is a company, while in other areas of structured finance, the assets are different, such as infrastructures (roads, hospitals, prisons, …), movable assets (planes, trains, ships ..) or financial assets (receivables, bonds, …).

LBO combines all the elements of a structured transaction :

1. use of an SPV
2. recourse to financial leverage
3. tax optimization

LBOs tend to attract more attention than other structured finance techniques, mainly because some companies taken over via LBOs were very known, such as Hilton, Harley Davidson, Picard Surgelés, etc ..

CHAPTER 1 – DISCOVERING THE LBO

1.1 The main characteristics

1- Definition

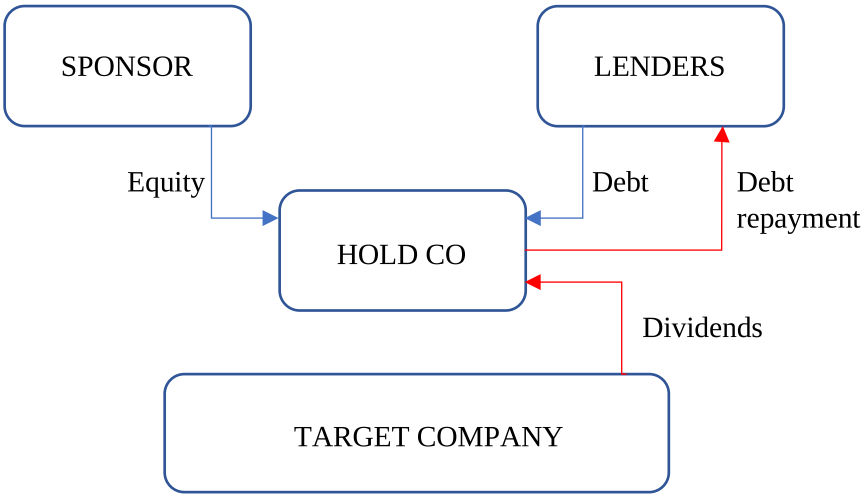
It is an acquisition technique that allows an investor (also called a sponsor) to buy a target company using a large amount of debt.
The buyout is structured using an intermediary company created for the unique purpose of acquiring the target company. This intermediary company, also known as an SPV, is an investment vehicle, which most of the time does not employ anybody.

➔ The SPV, which will be named Holding Company or Hold Co, is financed by debt and equity. The split between debt and equity depends both on the characteristics of the target and the market conditions at the time of the LBO. The equity is contributed by the buyer(s) of the target company, and the debt is provided by lenders (banks or specialists in debt instruments).

Once LBOed, the target becomes a subsidiary of the Hold Co : the debt is repaid using the dividends paid by the acquired company.

➔ The beauty of the LBO comes from the leverage used for the transaction. The buyer can acquire the company he is targeting, while contributing only a small part of the total amount of the target's value. How ? Because the balance is provided by the lenders. This is called « leverage » !

Simplified LBO structure



2- Leverage : working on the size of the debt

In an LBO, lenders take the risk that the target does not pay enough dividends to repay the debt.

The loan provided to the Hold Co is known to be **non recourse.**
What does it mean ?
Explanation :

- ➔ in case of default, lenders have no recourse to the sponsor
- ➔ there is no guarantee nor any type of credit protection from the equity investor, if the target does not pay enough dividends

So lenders only rely on a pledge of the shares of the Hold Co and the target company (a security package). These securities can be seized by the lenders to take control of the firms and try to restructure the transaction, or sell the company to repay for their loan.

Talking about interest rates, the ones used in LBO transactions are higher than thoses used in traditional corporate financing.

Lenders will size the debt according to the previsional cash-flow of the target, making sure that the company is able to pay dividends.

- In the case of small LBOs (sales of a few millions), the total debt will be a multiple of the net profit.
- For bigger LBOs, the acceptable level of debt will be expressed as a multiple of EBITDA (= Revenues – operating costs).

3- Various types of LBOs

- ➔ **MBO = Management Buy Out.** LBO in which the management of the target takes part in the buyout, alone or with another sponsor (very common, usually happens when when the owner of an SME retires, or when the LBO firm wants to keep the management team of the target.

- ➔ **MBI = Management Buy In.** LBO in which the buyers did not work for the target prior to the acqisition, but act as mlanagers after (ex : SME with new owners).
- ➔ **BOMBO = Buy In Managment Buy Out).** A mix of the 2 previous cases. Mabagers from the target partner with new managers (external) to buy out the target. An interesting case with new managers bringing thei expertise.
- ➔ **BUILD-UP =** acquisition carried out by company already under LBO. The new target is bought by adding debt (and sometimes equity) at the Hold Co level. A merger between the 2 companies can follow.

1.2 A three steps leverage

LBO are not only financing structures. They are transactions implying a high level of tax optimization, and that can only bear fruits if the implemented strategy works.

Very often, it is said that LBOs are based on a triple leverage :

- Financial
- Tax
- Managerial

a- Financial leverage

It is defined as the use of of debt to finance the acquisition of the target company. It allows sponsors to increase the impact of their equity investment (getting the control of the target with little capital).

Leverage is often expressed as as a multiple of the target EBITDA (example :4 times EBITDA, etc …). It increase the shareholders' when everything goes well, but it vcan be very dangerous when the debt level is too high.

b- Tax leverage

It comes second in terms of contribution to the performance of the LBO.

After the target acquisition, the sum of the taxes paid by the Hold Co and the target is generally lower than the amount of tax paid y the target independantly, before the LBO.

The exact impact varies from one country to another, depending on (i) the specific taxation system applicable to dividends, and (ii) the deductibility of interests.

Examples :

- Dividends paid to parents company are often taxed a very low rate (even tax exempt sometimes)
- In groups : many countries have designed specific tax provisions for companies belonging to the same group. These provisions are usually very beneficials for the various entities, allowing for very low taxation at the group level (+ interest deductability).
- Other solutions exist when the ones above (2) do not exist, such as a merger between the Hold Co and the target, or a debt push-down (debt being transfered to the target hen that one can increase dividends paid)

c- Managerial Leverage

The key to a succesfull LBO is the operating performance of the target : the ability to generate enough cash-flow to serve the debt and pay dividends to the new owners.

What does it mean ?

The management must find the right receipe to improve sales and profitability despite the additional pressure created by the large amount of debtraised by the Hold Co.

- LBO by investment firms (MBO, MBI, BIMBO).
  Management is instrumental to the success.
  LBO promotes the concept of managers shareholders, interested in the success of the LBOed company.
  Many sponsors favor transactions where the management co-invest (see MBO)

- Acquisition of an SME (Small Medium Enterprise) by an individual buyer
  In this case, the target is small. It is sold by an entrepreneur who has put his savings and his life into the firm.
  ⇨ The buyer usually does the same, so management is very important

- Build Up : In this case the managerial effect is smaller and limited, as the performance of the deal comes from synergies.

CHAPTER 2 – THE LBO STAKEHOLDERS

2.1 The target company

A- LBO always start with the search of a target. It is a long precess, usually done by a bank (M&A department). The investment bank tries to convince seller(s) that they can help them achieve a high valuation of their shares, and they present the opportunity to potential buyers.
Doing so, they position themselves to advise the sale (sell-side advisors) or the acquisition (buy-side advisors).
For SME, the market is usally animated by small actors specialized in M&A.

The potential buyers have their own requirements. Among these buyers, LBO firms have their own investment policies, which set several criterias sucha s the size (defined by Sales or EBITDA), the sector, etc …but mainly **recurring cash-flow and growth perspectives** (because of the debt servicing expected).

LBO firms often have 5 criterias for their investments :
- established companies
- operating in mature market
- if possible in a niche segment with limited competition
- where demand is stable
- and alternatives are limited

Examples :

- Firms with strong brand names and loyal customer base
- Chains of specialized stores

The possibility of improving the operating process is also an important factor for the buyer(s). These targets usually have a « lazy » management team, so operating improvements exist, (optimization of the supply chain, upgrading the production facilities, the rationalization of the costs, a better organization, etc …).

Managerial leverage is most effective in such target companies ! (see Harley Davidson case)

B- Organic growth and external growth

Organic growth can be achieved in different ways :

- Products/services can be added or improved
- New marketing strategies can be implemented
- New clien can be targeted

External growth is another way to create value for an LBO. Build-up allows the company to grow faster, which is very appealing to Private Equity firms (PE), given their investment horizon. If synergies are correctly identified and implemented, then external growth can be the fastest way to increase the valuation of the target.

C- Low level of Net Long Term Debt

Targets should have a low level of Long Term Debt, because of the intrinsec characteristics of an LBO.

➔ LBO buyers avoid firms in sectors which require large and regular CAPEX (Capital Expenditure), and targets that need to entirely replace old productions tools (machineries, facilities, lines, etc …)

Cah-flow generation being key to support both the existing target debt, and the new acquisition debt, buyers always analyze the leverage of a target as a whole. They compare the EBITDA of the target to the sum of the target's own debt + the acquisition facility to ensure that the leverage is sustainable. Therefore, the target iis usually not in a capital intensive sector such as car manufacturing.

D- Low working capital requirements

Working Capital Requirements (WCR) is the amount of cash needed by a company to operate its day-to-day business. It is computed as the sum of accounts receivable and inventory minus accounts payable.

WCR can be financed :

- By using bank overdraft or short term facilities
- By securing long term liquidity (additional equity or debt)

Hint : Banks usually do not finance LBO when targets have high WCR

In some cases, WCR is negative. It happens when the target generates a lot of cash (see supermarkets, restaurants chains, etc …).

Exceptions : LBO may invest in companies with high WCR when they believe that such WCR is due to a poor management, sot hey can change the current level by improving the operational process.

E- Some assets can be used as collateral

When the target company own assets which have a specific value (independant from the company's business activity, such as offices, trademark, buildings, …), then these assets can be pledged to get funding from lenders.

F- No hidden potential problems

Before making an offer to acquire a company, buyers perform a due diligence (DD). This process consists of verifying all information made available by the sellers, a well as the market in which it operates.

The DD is supposed to cover all aspects of the transaction, and includes financial, legal, technical and commercial matters. In performing a DD, the potential buyer tries to make sure he will not have any unpleasant surprises after the acquisition process is closed.

In the case of large LBO, teams of advisors are retained to perform the DD process :

- Financial advisors (banks, M&A boutiques) work on the valuation of the target
- Commercial advisors (consulting firms specialized on strategic matters, such as BCG, McKinsey, etc ..) work on the potential of the target (analye the competition, study the market)
- Technical advisors, (specialists) assess the existing assets (quality), look at potential technical problems and the costs associated
- Legal advisors analyze the main contracts between the target and third parties, verify the applicable regulations if any.
- Audit company work on the target's financial statements
- A Tax advisor can be hired to give its analysis on the fiscal aspects of the LBO (and/or the target's tax returns)

In the case of small LBO (individual buyers), only law firms and accountants are hired in order to reduce the overall process costs. The risk of negative surprises is therefore higher.

➔ In all LBOs, buyers require **a liability guarantee**. This is a document in which the seller accepts to be liable for the consequences (financial, tax, legal, etc …) of any action taken when itw as still the owner of the target.

G- Human Ressources

For an LBO firm, it is much easier to keep a target's management team rather than to appoint a new one. The existing team knows the business insideout, and can be incentivized to ourperform and deliver the expected growth.

Hint : Prior to the closing od the LBO, one of the most important decisions is to decide how many managers will become shareholders of the target. This exercise is difficult because the choice will have an impact on the performance of the team.

Another issue is the « inhouse culture » of the target. Successful LBO are usually able to promote a new work ethic among the staff of the target. Example : constant attention to details has a positive impact on profitability.

2.2 <u>The buyers</u>

<u>Private Equity Firms (PE)</u>

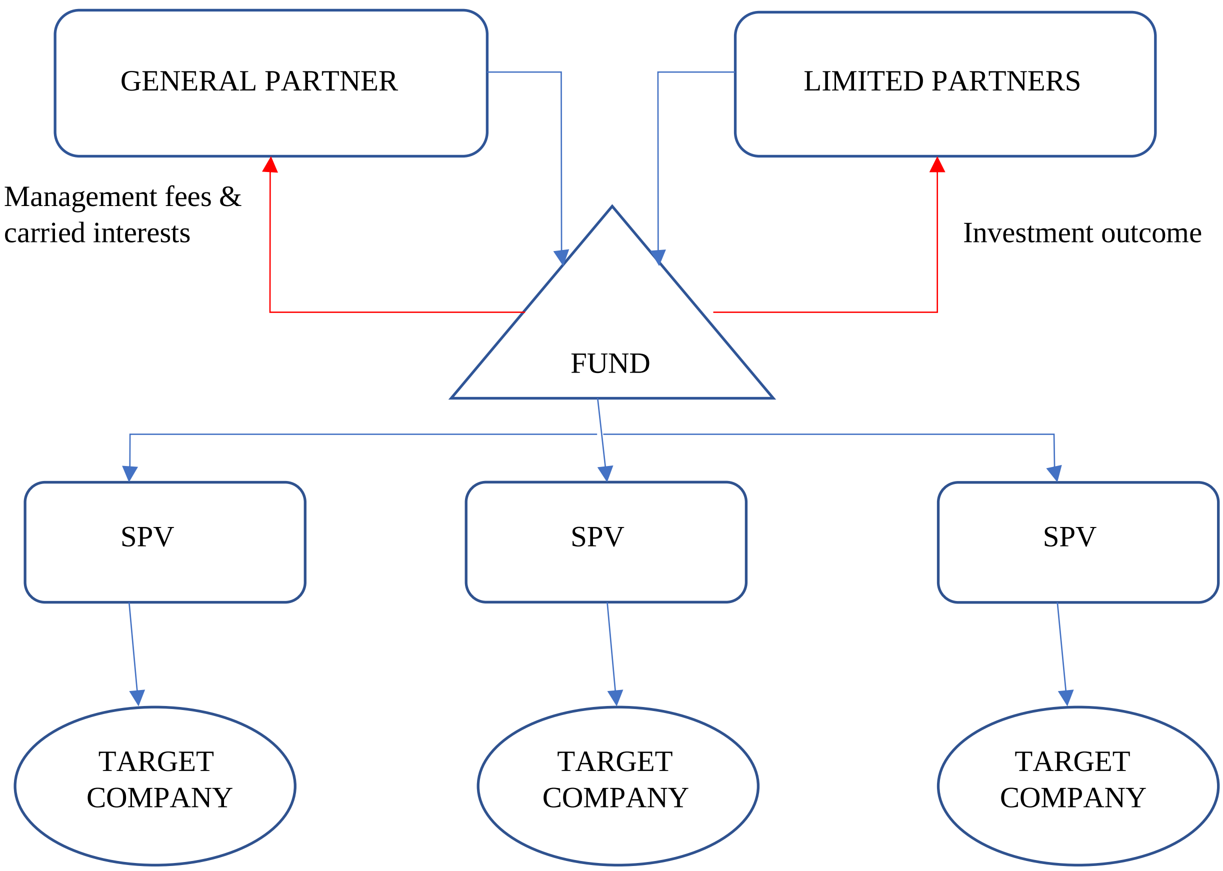
Most LBOs are made by investment firms, known as PE sponsors. Their goal is to acquire a company with a high level of financial leverage, to develop it and then to sell it or get it listed on the stock exchange, with a profit after 3 to 8 years (average 5 years).

A- LBO firms versus LBO funds

Each LBO firms has its own startegy. LBO firms never buy directly a target. The acquisition is made via a fund set up by the LBO firm, with sole purpose of buying out companies.

LBO firms are not funds : they are management companies which raises money from investors (such as insurance companies, pension funds, sovereign funds, etc …) through a separate entity (a fund) to proceed with the acquisition.

<u>Fund structure in the LBO sector</u>



<u>General rule :</u> The LBO firm is the General Partner (GP) and investors contributing to the fund are Limited Partners (LP). These last investors are passive, their goal is to generate a profit.
GP makes usually only a small investment in the fund, and they have a « multiple » task (rôle) :

- it must create the fund and design its strategy. Each fund has a specific position in terms of sector, size, etc ..

- it must identify and convince potential investors
- it selects target companies
- it structures the acquisition(s), which means they are in charge of the coordination with the lenders, the work on the debt, the equity, etc …
- it makes the investments => the investors are asked to deposit money in the funds when targets are acquired, nor prior to the transaction. There are issuances of **capital call** at each acquisition. The amount called depends on the investor (LP) participation in the fund (% of the total amount being raised when the fund was created)
- it manages the fund participation (day to day monitoring of the investments)
- it is in charge of selling the LBOed companies

B- Sharing the profits between GP and LP

In an LBO structure :

- LP receive an investment income derived from the performance of the fund (some of the profit generated)
- GP receives management fees + carried interests. Management fees are paid annually, calculated as a predefined percentage of the capital committed by the LPs (2% on average). This percentage decreases once all capital committed has been deployed.
  In addition to the fees, investment funds collect a portion of the fund's profit above a certain level of performance.This portion is called « carried interests ». It amounts usually to 20% (carry level) of the sums received by LPs above a pre-determined return (carry hudle). The carry hurdle varies depending on the type of investment targeted, teh country, etc ..

C- Funds lifetime

Usually 10 years after which the fund is closed and the money return to investors.These 10 years are divided in 2 parts : the first 5 years which is the investment period, and the last 5 year which is the divestment period. An extension of the lifetime is possible in special occasions (difficult divestment). New funds are raised every 4 to 5 years.

D- Performance targets

PE firms only buy out a company when they believe that they can obtain a return in line with pre-determined target (on average 18 to 20 % per year). The return is computed as a weighted average of the returns of various acquisitions within the fund

<u>Individual buyers</u>

They constitute a large part of the buy-outs, as there are a lot of SME sold by entrepreneurs willing to retire or exit. Buyers are often the children of the owner, or an executive from the company ; the size ranging from 500.000 to 10 million euros ; th equity brought by the buyers ranging from 100.000 to 500.000.

2.3 The lenders

Reminder :

- LBO debt is sized according to EBITDA of the target
- Leverage is expressed as a multiple of the EBITDA

Generally speaking, mature and resilient business are able to support a higher level of leverage than others.

Also, the level of debt depends on the market conditions at the time of the transaction. The acquisition debt is sized considering the net debt of the target itself + the acquisition debt being raised by the Hold Co

➔ The total leverage of the deal is the sum of the acquisition debt and the loans taken out by the target company, minus the cash available at the target company level.

The debt structure depends on the size of the target : if the firm is small, there will be one tranche of debt only ; if the company is big, there may be several tranches (senior with low interest, and junior with high interest)

Finally, the debt structure depends also on the country of the deal and the financing tools available.

A- Term loans

Also called senior loans, they are used in most of the LBOs. They are secured by a pledge on the shares of the Hold Co and the target company.

Term loans rank senior to other tranches of debt (when several tranches are needed).

Sometimes, the senior debt itself is divided in several tranches :

- Term Loan A amortizes totally or partially, and has a maturity of 5 to 7 years
- Term Loan B is a bullet, interest only loan, with a maturity around 7 years
- In some cases, Term Loan C is structured, as a bullet loan with a longer maturity than Term Loan B

These loans are pari passu in terms of seniority, but interest rates are higher for each loan.

Hint :

- Small buy outs have only amortizing loans.
- Sometimes, large buy outs have no Term Loan A, but only Term Loan B which are attractive to PE sponsors

Covenants : They are a legal protection used by lenders in loan agreement. They represent a commitment of the borrowers to perform or refrain from some actions. A breach of covenants triggers sanctions for the borrower, such as early repayment of the debt, lay-off for the managers, etc …

There are 2 types of covenants :

- Affirmative covenants = actions that the borrower must perform
- Negative covenants = activities that the Hold Co is barred from.
  Examples : (1) commitment not to use the proceed of the loan for financing anything else than the acquisition ; (2) commitment not to take anyadditional loans without prior unanimous consent from the lenders.

Sometimes, there are also financial covenants, linked to specific financial ratios to maintain, such as Net Debt / EBITDA (which is the leverage ratio)

Event of Default : Tehy are pre-defined events (or circumstances) where lenders have the right to ask for an early repayment of the loan.

Cov-Lite structure : covenant lite loans have fewer restrictions than traditional loans. Appreciated by the borrowers because of their given flexibility, they very often exclude financial restrictions such as leverage ratios limits.

Banking Pools : For large LBOs, several lenders commit to provide the funding of the transactions, but they also want to be able to sell the debt later to other lenders. In such case, the **financing takes place via an underwriting.**

Non-bank investors : When an underwriting takes place, lenders do not sell the debt to other banks but to non-bank investors, often specialized in leverage loans (non investment grade rating). The reason for selling these loans : they are very high risk weighted assets.

Other credit facilities : they mainly are

- Revolving credit facility = credit line that can be drawn anytime and used for WCR (Working Capital Requirements)
- Specific CAPEX facility = in case the company needs to make an investmentto upgrade its equipment.
- An acquisition facility = provided at the Hold Co level for build-up strategy

B- Subordinated Loans

They rank below senior debt, with respect to the claims on earnings or assets.

Also called junior debt, they are mainly used for large LBOs.

Second Lien : Some LBOs include a debt instrument called Second Lien. It is a tranche of debt that has equal payment rights to the senior debt, but has subordinated rights to any collateral given by the borrower to the lendres.

Example : Second ranking pledges over the shares of the Hold Co and of the target company.

In pratice, they are a junior debt instrument.

C- Mezzanine Debt

This is a tranche of debt which is junior to the senior debt, but still senior to the equity. It is a hybrid type of financing that is midway between debt and equity.

Mezzanine debt is a bullet loan, with proceeds flowing from a miw of

- Interest payments during the life of the loan
- Capitalized interest, paid at maturity or when the LBO is refinanced, called PIK (Payment In Kind)
- Warrants on the equity of the company. Warrants are an option for the mezzanine lender to be paid interest in a pre-defined percentage of equity of the Hold Co. It can be very attractive to participate to the growth of the company !

Mezzanine debt is a good way to add leverage in an LBO without putting pressure on the senior lenders risk profile.

Mezzanine lenders are debt funds , which can also invest in Second Lien. These 2 types of debt are generally mutually exclusive.

D- High Yield Bonds

In an LBO, the junior tranche can also take the form of high yield bonds issued by the Hold Co or by an additional SPV situated between the Hold Co and the sponsor. When issued by the Hold Co, these bonds, also called junk bonds, are usually rated non investment grade, and referred to as subordinated notes.

E- Unitranche Debt

It is a debt instrument offered as an alternative to the senior and mezzanine debts.

It is called unitranche because the loan replace the 2 intruments named above. Unitranche is non-amortizing, its maturity is usually 5 years, it is priced as a weighted average of senior and mezzanine debt. This instrument often coy the coupon characteristics of a mezzanine with a mix of (1) cash interest being paid during the life of the loan, and (2) PIK paid at maturity, and (3) warrants.

Unitranche is considered the most popular tool today. It is not provided by banks, but by funds specializing in private debte (called direct lenders). These funds are similar to LBO funds (structured with GP, LPs, and an SPV). Finally, they are active in mezzanine and second lien instruments.

Examples : Bain Capital, Carlyle, etc ..)

<u>CHAPTER 3 – THE LBO PROCESS</u>

<u>3.1 The sale process</u>

Each sale process is different, depending on its size and the seller strategy.

Private companies which attract major PE firms are usually auctionned. The schedule is precisely monitored, with a strict calendar.

The sale process comprises different steps organized according to a pre-determined calendar, so bidders are equelly treated.
Sometimes, a company is being sold without ever being put on sale, just as a result of an unsollicited offer from a bidder. Among others, this is the case of Public companies being taken Private, such as Hilton Hotels, or Manchester United… but also for a lot of the small companies.

A- Preliminary Analysis

It all starts with a simple analysis of potential targets. When a firm is selected, a teaser is established for potential buyers. If a buyer is interested, he signs an NDA (Non Disclosure Agreement) as a mark of interest. At this stage, the potential buyer is providing with more information via an document called an Info-Mem (nickname for Information Memorandum). A contact is established between the 2 Parites and a database with all available data about the target, is open.

B- Valuation of the target

At least, 2 valuations are processed : an intrinsec one based on Discount Cash-flow Analysis, and a comparative one, using a benchmark and multiple of SALES and EBITDA These valuations will help determining the offer price.

Beware : valuation and pricing are 2 different exercises !

For PE firms, the price to be offered is often set as follows :

1- PE firms modelthe future financial flows over 5 years, based on assumptions of growth and costs.
2- They anticipate an exit multiple at the maturity (5 years) : they estimate a value of the target based on a multiple.
3- They substract from this theoretical valuation the amount of debt they think the LBO could support at that date. The result is the equity valuation of the target.
4- Finally, considering the return objective of their fund, they can find out the amount they are ready to pay today to acquire the target company.
5-

C- Letter of Intent

When a buyer confirms his interest in a target company, he does so through a Letter of Intent. Also named LOI, it is a non-binding document which includes :

- The terms of the transaction (total or partial buy-out)
- The offered price (including the assumptions)
- The payment structure (debt and equity)
- The extent of the due diligence to be done
- The transaction schedule
- Eventually a non-compete clause to be signed by the seller
- The exclusivity for a specific negotiation period of time

In the case of an auction, the seller may receive many NBO (Non-Binding Offer)

D- Due dilligence

The bidders still competing after an LOI ent, enter a due diligence period, with the opening of a database.

E- Structuring and closing

Lenders and LBO firms share the following informations :

- Maximum total leverage accepted
- Percentage of the facility that the Lenders are willing to finance (including underwriting amount)
- Loan profile (amortizing fully, partly, or not)
- Margin and upfront fees
- Covenants

When the ris a competition between buyers, some lenders may be invited by several bidders. If so, lenders will dedicate different teams to the analysis of each bid. These teams are not allowed to communicate each other (chinese wall) on the deal and the bidding strategy of their clients.

Once a bidder is chosen, the buyer and the seller enter into an excusive negotiation called exclusivity period. They finalize the transaction and agree on the Shares Purchase Agreement (SPA).

SPA is a legal document through which the ownership of the target is transfered from the seller to the buyer. The closing of the debt transaction is done simultaneously.

F- After the acquisition

- The buyer focus on the strategy and the operating performance
- KPI (Key Performance Indicators) are set
- Contacts are established on a regular basis between the LBO firms and the management team of the target

3.2 The exit strategy

There are different ways for the LBO firms to exit the LBOed company. We will mention a few of them as a conclusion of that chapter :

(1) IPO = Initial Public Offering. The LBO firms sell the target company to the public, on the stock-exchange.

(2) A sale to another company is more common than an IPO. Buyers can be direct or indirect competitors of the company. They can also be suppliers or clients.
They are named strategic buyers, because they want to expand their activities and to capture synergies.
The company can be sold in parts if it is more profitable to the owners.

(3) A sale to another PE firm can also take place. In such a case, one talk about a financial buyer (see Picard surgelés)

Finally, a **dividend recapitalization** can be done.

It allows a PE firm to monetize its investment without selling its stake in the target company. The technique consists in refinancing an LBO with more debt at the Hold Co level, to pay-out an extraordinary dividend to shareholders.

This tool is often used when no real exit options are available.