Corporate Valuation, Restructuring and M&A's

Going Private and Leveraged Buyouts

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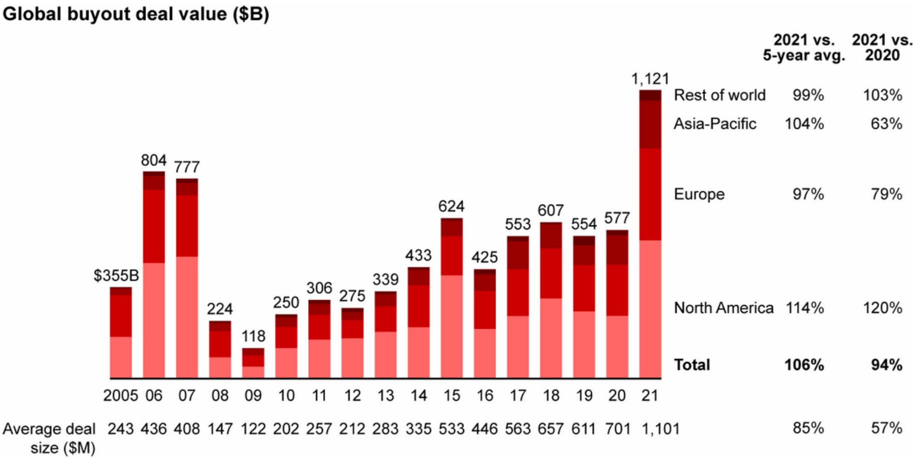
Introduction

- Leveraged buyout (LBO): A small group of investors acquires all of a (public or private) company's equity
  $\rightarrow$ Management Buyout (MBO) if the management team is involved
- Acquisition financed with debt backed by the target's assets
- Result: Private firm with very high leverage (up to 95%!).
- Post-LBO:
  $\rightarrow$ Restructuring, acquisitions, asset sales, etc
  $\rightarrow$ Cash sweep: Debt is rapidly paid down (e.g. over 5 years)
  $\rightarrow$ Exit (after e.g. 5 years): Reverse LBO, trade sale

Pros and Cons of Being Public

- Advantages of being a public firm
  → Access to capital markets
  → Risk diversification
  → Higher publicity (media exposure)
  → Use of stock price-based remuneration packages
- Disadvantages of being a public firm
  → Agency costs and value destruction
  → Direct and indirect costs of listing
  → The eclipse of the public corporation
- Some investors may think that being private can generate higher value for a particular company

Global Buyouts Over Time



Source: Bain

Sources of Value in LBOs

1. Better firm performance
2. Mispricing
3. Value Transfers from Other Stakeholders

Better Firm Performance

- Main sources of efficiency gains
  1. Cut costs
  2. Better control of Inventories, A/R, etc
  3. Terminate some investments, start some others
  4. Sell some assets/divisions
- Restructuring is not only downsizing: Often, new capital injected
- Note: Little scope for operating synergies
- These changes could be done without an LBO!

Better Firm Performance – Incentive Effects

- Management
  - Large equity stake + incentive plan
  - Small part of financing, but much of own wealth at risk
  - Management team is crucial. Can they take the heat?
- Kaplan (1989): MBOs
  → pre-MBO: CEO = 1.4%, all managers = 5.9%
  → post-MBO: CEO = 6.4%, all managers= 22.6%
- Incentive plans
  → All LBOs: at least 1 plan (75%: 2 incentive plans) (Muscarella & Vetsuypens 1990)
- High leverage + Cash sweep
  → Need to pay out FCF, cut costs, and more generally, cut organizational slack

Exploiting Mispricing

- "Farming" view of LBO
  → Buy low & Sell high
- Remark
  → Will happen mechanically in rising markets
  → May have provided much of the gains during the 1990s
- Gou, Hotchkiss, and Song (2011) argue that returns are not only generated by operating performance
  → Changes in industry multiples is at least as important as operating improvements

Exploiting Mispricing

- “Do MBO managers tend to buy the firm on the cheap?
- Assumption: The offer by managers does not reveal information about the true value
- Negative evidence
  $\rightarrow$ Premia is not higher in LBO vs. MBO
  $\rightarrow$ MBOs often underachieve projections (Kaplan 1989).
- Careful: Sometimes management/insiders are net sellers of equity in LBO even if the fraction of equity they hold increases

Transfers from Government

- Very high leverage implies very high interest tax shield
  $\rightarrow$ The average LBO pays no taxes for 5 years (Lowenstien, 1985).
  $\rightarrow$ Little or no dividends $\rightarrow$ Lower personal tax
- Important but not the dominant factor
  $\rightarrow$ Very high leverage is only temporary
  $\rightarrow$ Tax savings are predictable $\rightarrow$ Built into the premium (Kaplan, 1988)
  $\rightarrow$ Therefore, some papers find that a big portion of tax benefits is captured by pre-buyout shareholders.

Transfers from Other Stakeholders

- Existing creditors/Preferred stockholders: Risk-shifting?
  $\rightarrow$ Covenants may not be sufficiently protective
  $\rightarrow$ Some evidence
  - Bondholders lose. Risk-adjusted loss of 3-7% (Asquith & Wizman 1990, Warga & Welch 1993)
  - Small relative to the gains to pre-LBO shareholders
- New creditors: New creditors may underestimate the default probability due to high leverage
  $\rightarrow$ The interest rate could be lower than the actual risk suggests
  $\rightarrow$ No systematic evidence
- Employees: Breaching implicit contracts
  $\rightarrow$ No systematic evidence

LBO Exit

- BO specialist and principals "cash out"
- Main outcomes after 5-6 years (on average):
  $\rightarrow$ Reverse LBO: Secondary Initial Public Offering (SIPO).
  $\rightarrow$ Sale to a corporate (i.e., strategic) buyer
  $\rightarrow$ New LBO
  $\rightarrow$ Chapter 11
- Sometimes, buy other firms before undertaking a (roll-up) IPO

Profile of a Good LBO Candidate

- Should be able to bear a huge debt
- Cash flows
  $\rightarrow$ Stable, repeatable, predictable
  $\rightarrow$ Industry: Mature, stable, recession-proof
  $\rightarrow$ CAPEX: Low, predictable needs
  $\rightarrow$ Market position: Good, established, strong brand, insulated
  $\rightarrow$ Liquid B/S, collateralizable assets, excess cash, securities
  $\rightarrow$ Separable non-core assets
  $\rightarrow$ Low current leverage
- Potential for efficiency gains
  $\rightarrow$ Room for cost reductions
  $\rightarrow$ E.g., Bust-up unit MBOs, family firms

Things to Worry About

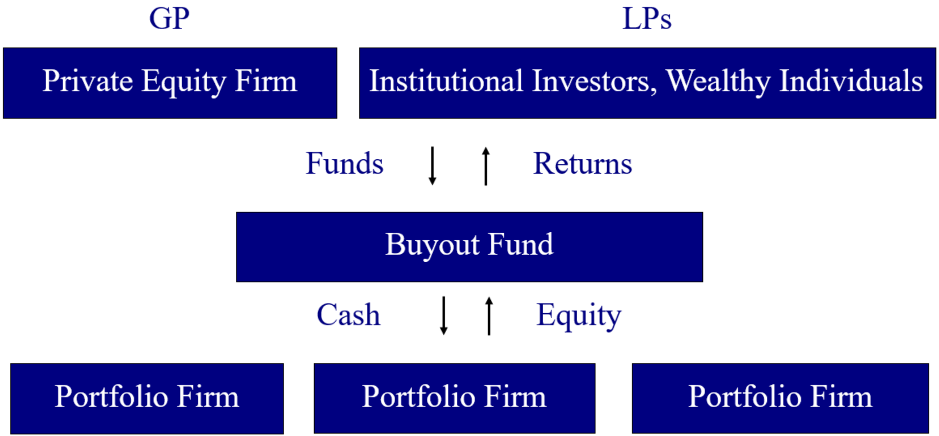
- Pricing: Complex and risky claims in complex capital structure
- LBO per se does not create value!
  $\rightarrow$ Need potential for improvements
- Management is crucial
- Exit
  $\rightarrow$ Why isn't there a trade buyer today?
  $\rightarrow$ Why will there be one in 5 years time?
- Debt is dangerous!

Private Equity Funds

- Private Equity funds are partnerships
  $\rightarrow$ There are two types of partners: Limited Partners ("LPs") and General Partners ("GPs")
  $\rightarrow$ General Partners are responsible for the management of the partnership and for the investments ("portfolio firms")
  $\rightarrow$ Limited Partners provide capital for the partnership

Private Equity Funds

Buyout Funds – Venture Capital Funds



Private Equity Funds

Fund Structure

- Private Equity funds are limited duration closed-end funds
- A partnership normally lasts for 10 years
  $\rightarrow$ but may be extended for 2 years if LPs allow
- The GPs reserve the right not to accept funds
  $\rightarrow$ Important! This means that one cannot invest in just any fund
  $\rightarrow$ Also, sales of LP stakes normally not allowed
  $\rightarrow$ So LP structure may be very stable
- Limited Duration
  $\rightarrow$ Powerful incentive device
  $\rightarrow$ Without proper success, new funds are impossible to raise

Reasons for Limited Duration / Partnership

- Incentives
  $\rightarrow$ The limited duration ensures that investors get back their money
  $\rightarrow$ Closed end funds with unlimited duration are hard to sell
  $\rightarrow$ Also forces the GP to be reevaluated by the market on a regular basis
- Taxes matter
  $\rightarrow$ Partnership allows distribution of shares without triggering income taxes (Pass through)
  $\rightarrow$ Low rate on capital gains in the US (15% only) regardless of whom has provided the capital

Performance of LBOs and Private Equity Funds

- Two distinct performance issues
  1. Performance of firms that are taken private
     $\rightarrow$ Are the gains to LBOs positive?
     $\rightarrow$ Challenging task to answer since these firms have been taken private
  2. Performance to investment in private equity
     $\rightarrow$ Do the LPs earn profits from their investment in the private equity fund?
     $\rightarrow$ Challenging task to answer since Private Equity funds are partnerships
- Note that 1 does not imply 2 since the GP takes some of the gains as well

Performance of Private Equity Firms

Kaplan and Schoar (2005)

- Net-of-fees returns to PE funds are roughly comparable to the SP 500 (or even slightly under).
- This analysis may actually overstate the returns because it relies on voluntarily reported data and hence suffers from survivorship bias (i.e. funds that fail won't report data)
- These returns are not risk-adjusted!
- There is considerable variation in performance across PE funds. Unlike the mutual fund industry, there appears to be performance persistence in PE funds

Conclusion

LBOs create value through

1. Operating performance (Kaplan 1988)
2. Increases in industry multiples
   $\rightarrow$ Gou, Hotchkiss, and Song (2011) argue that returns are not only generated by operating performance: Changes in industry multiples is at least as important
3. Tax shields to a limited extent
   $\rightarrow$ Debt is often high at the start and rapidly decreasing