Corporate Valuation, Restructuring and M&A's

Going Private and Leveraged Buyouts

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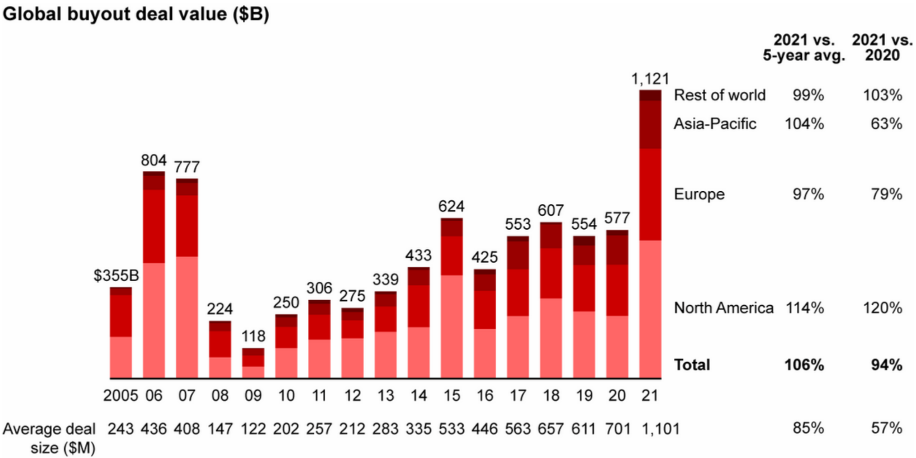
Introduction

- 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
  $\rightarrow$ pre-MBO: CEO = 1.4%, all managers = 5.9%
  $\rightarrow$ post-MBO: CEO = 6.4%, all managers= 22.6%
- Incentive plans
  $\rightarrow$ All LBOs: at least 1 plan (75%: 2 incentive plans) (Muscarella & Vetsuypens 1990)
- High leverage + Cash sweep
  $\rightarrow$ 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

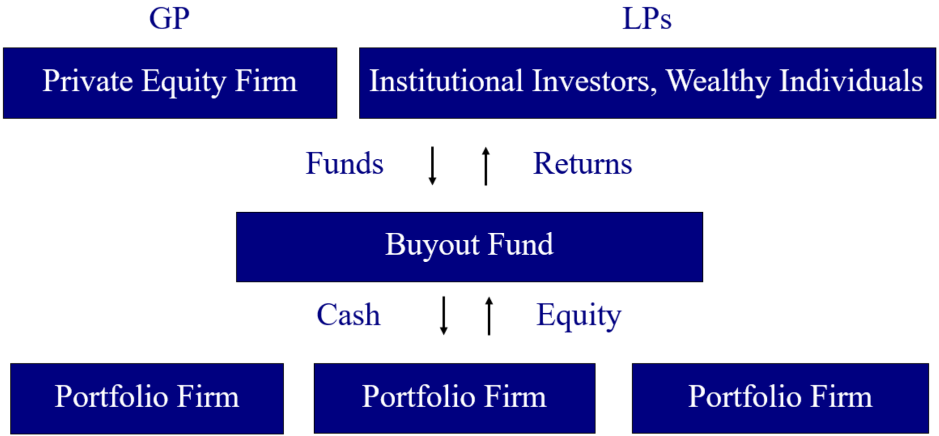
- Pricing: Complex and risky claims in complex capital structure
- LBO per se does not create value!
  $\rightarrow$ Need potential for improvements
- Management is crucial
- Exit
  $\rightarrow$ Why isn't there a trade buyer today?
  $\rightarrow$ Why will there be one in 5 years time?
- Debt is dangerous!

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
  → The limited duration ensures that investors get back their money
  → Closed end funds with unlimited duration are hard to sell
  → Also forces the GP to be reevaluated by the market on a regular basis
- Taxes matter
  → Partnership allows distribution of shares without triggering income taxes (Pass through)
  → 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

Private Debt

- There is a decline in the number of listed firms in the US
  - → Regulations make being public costly for firms
  - → Around 5 million USD per year
- The banking regulation has been stricter
  - → Corporate loans are risky, demanding more bank capital

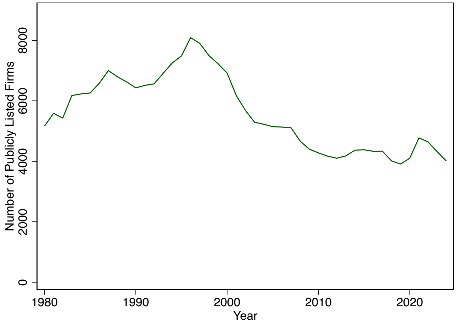


Figure 1: Public Firms

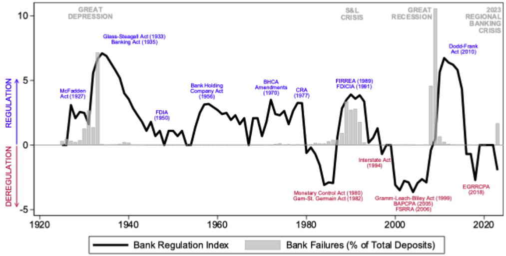


Figure 2: Bank Regulation

Private Debt-BCDs

- How do the firms finance their activities?
- After the global financial crisis, firms have been obtaining loans from direct lenders
  $\rightarrow$ Business development companies (BDCs), private debt funds, collateralized loan obligations (CLOs), etc.
- BCDs: Closed-end investment company.
  $\rightarrow$ Issue shares when the fund is established. No new shares are created afterward.
  $\rightarrow$ Trades on an exchange like a normal stock
  $\rightarrow$ Because the fund does not redeem shares at net asset value (NAV), its market price can differ from the underlying value of its assets
  $\rightarrow$ Must hold at least 70% of investments in eligible assets (government bonds, investments in eligible firms)
  $\rightarrow$ Must provide significant guidance to their portfolio firms

Private Debt-BCDs

- BCDs start by private funding. Then, raise equity via an IPO.
- BCD leverage is restricted: minimum debt-to-equity ratio of 33%
- Tax advantage: If a BCD distributes at least 90% of its income, it doesn't pay taxes on its income.
- As BCDs are publicly traded, they may enable retail investors to get exposure to private firms.
- BCDs can substitute bank loans!
  $\rightarrow$ Access to BCD allows firms to increase their employment and patenting activity (Davydiuk et al 2024)
- BCDs can obtain loans from banks, which, in turn, are used as loans to risky firms
  $\rightarrow$ Why?

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