Mergers and Acquisitions MBA776A

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Leveraged Buyout

Introduction

- Leveraged buyout (LBO)
  - An acquisition where acquirer finances the buyout predominantly through debt and less through equity
  - Debt to the extent of 50% to 90%
  - These transactions are highly leveraged: <u>high financial risk</u>

- **Main objective for LBO:** Garner high return on equity (ROE) through leverage to enhance return on investment
  - The high debt taken is to be paid off
    - Through cashflow generated by the target
    - Asset stripping of some subsets of the target firm

Management Buyout

- Management buyout (MBO)
  - Purchase of company's equity capital by existing management of the company
  - Financing offered by a group of financial investors such as investment bankers (IB), hedge funds (HF), high net worth individuals (HNIs), and private equity (PE)
  - Differs from LBO

Who are the LBO sponsors?

- Financiers
  - Confidence in the deal
  - Liquidity at hand
  - Time to wait for expected high return on their investment

- Category of investors: **‘Financial Sponsors’**
  - PE funds
  - Investment banks
  - Hedge funds

- Victor Posner (DWG Corporation): coined the term **‘LBO’**
  - **Strategy:** buy ***‘low valuation – level cashflow – low debt’*** companies through LBO

LBO modes of Target Acquisition

- Acquire a public company and then take it private

- Acquire any company and then immediately do divestiture
  - Asset stripping

- Private company and Entrepreneurial Ventures

How to select an LBO target

1. Mature Industry/Company
2. Non-cyclical stable cashflow
3. Strong management team
4. Strong balance sheet
5. Advantage in terms of ‘core competencies’
6. Saleability of assets
7. Smooth Exit Options
8. Scope for improving operating margin

Financial and Business Criteria for an LBO

Financial Criteria

1. Consistent **profitability** of target firm
2. Scope of improving **operating margin**
3. Good quality long-term cash flows to **service debt**
4. Good quality **subset of assets, liquid** enough to generate interim cashflow
5. **Low capital expenditure and working capital** requirement

Business Criteria

1. Efficient management with knack to **deliver results in short term**
2. **Strong product** and service offering
3. Strong **competencies** to yield good **stable cashflows**
4. **Low business risk** ensuring low fluctuation in profits, and hence **stable cashflow**
5. **Long** product and technology **life cycle**

LBO: Instruments used in financing

- Loans
  - Term loans, Revolving credit facilities, Bridge loans

- Senior debt securities

- Junior debt securities

- Mezzanine capital
  - Fills the gap between senior debt and equity
  - Right to the debt capital provider to convert to equity if debt is not paid back

- Normal equity

A typical LBO’s Capital Structure

Fund Type	% Weight	Cost	Source
Term Loan	10 – 30%	Low Cost	Commercial Banks
Senior Debt Security	20 – 30%	Low Cost	**I-Banks, PE, Insurance Companies, Hedge Funds**
Junior Debt Security	**50 – 70%**	**High Cost**	**- Same as above-**
Mezzanine Capital	**10 – 20%**	**High Cost**	**- Same as above-**
Revolving Credit	5 – 10%	Low Cost	Banks
Equity Capital	10 – 30%	High Cost	Management

Mezzanine Capital and its relevance in LBOs

- Regulations governing 'Term Loan' lending by commercial banks
- Need for long-term finance in the LBO

- Mezzanine Capital:
  - More flexible than term loans
  - Less expensive and less dilutive than equities
  - Fills the financing-gap between senior debt and equities
  - More often without any collateral requirement
  - **Popularized by**: Michael Milken and Drexel Burnham Lambert – the **junk bond kings**

Qualities of different Capital Sources

Particulars	Senior Debt	Mezzanine Debt	Equity
Security	Secured	Subordinated	None
Rating	**Senior**	**Second**	**Last**
Terms	**Tight**	**Flexi**	**None**
Period/tenure	Demand	Term/Flexi	None
Coupon	Floating	Fixed	Dividend/Capital gains
Rate	**LIBOR+**	**Risk adjusted**	**Market risk linked**
Equity option	None	Warrants	Shares
Prepayment penalties	Yes	Yes	No
Providers	**Commercial Banks**	**Investment banks, PE**	**Private investors**
Liquidity	**High**	**Low**	**Low**
Risk	**Low**	**High**	**High**

Financial leverage: source of risk in an LBO

- Financial leverage magnifies the result of firm by using fixed cost financing

- Interest tax shield

- **Higher** ratio of debt to equity <u>causes profitability to vary more</u> when earnings on assets change **<u>than</u>** it would if the ratio was **lower**

- **Double-edged sword**
  - Create wealth and also deplete it
  - An example:
    - An investment to buy an INR 1,00,000 asset with INR 10,000 (10%)
    - **Increase** in value by 10%; **100% return** on invested capital (ignoring the interest part)
    - **Decrease** in value by 10%; **100% loss** on invested capital (ignoring the interest part)

- Degree of financial leverage **(DFL):** <u>favorable or unfavorable</u>

Financial risk associated with financial leverage

- Financial risk
  - Degree of financial leverage (DFL)
  - Inability to cover the firm's fixed financing costs

- Business risk
  - Degree of operating leverage (DOL)
  - Inability to cover the firm's fixed operating costs

- Total risk
  - Degree of total leverage (DTL)
  - Highly leveraged firms, with operating leverage multiplies risk of being unable to meet the debt repayments at any time the sales decline

- **Implication:** Firms in unstable industries (prone to high business risk) must attempt to use less debt in comparison to those subject to only moderate fluctuations

History of LBOs

- Started around 1955
  - Acquisition of Pan Atlantic and Waterman Steamship by McLean Industries

- Victor Posner popularized the 'LBO' in 1969
  - NVF bonds and exchange of shares for long-term bonds in LBO of 'Sharon Steel Corporation'

- Involvement of marquee PE investors like KKR and development of **junk bond markets**

- 1980s boom
  - Corporate raiders: RJR-Nabisco deal
  - Asset stripping

- LBOs in 2000 – 2007
  - Equity contributions (30-32%), and debt contributions (60-70%)
  - Payable in kind (PIK)

- LBOs in 2010 onward
  - Equity contributions have gone up (40-45%)

Theories of LBOs

- Free Cash-flow Theory
- Tax Advantage Theory
- Agency Theory

Exit Strategies for LBO

- Reverse LBO
- Sale to Strategic Buyer
- Second LBO

LBOs in India

- Tata – Corus Deal
- Hindalco (Aditya Birla Group firm) – Novelis Inc. Deal

- **Assignment (Group):**
  - Pick one of the above two deals (or any other recent LBO)
  - Analyze the deal on the basis of **‘Financial Criteria’ and/or ‘Business Criteria’**
  - Analyze the **post deal performance** and comment on success/failure of the deal focusing on their LBO nature’
  - Would non LBO acquisition have been better? Critically discuss with supporting analysis and an illustration of changes in Capital-Structure mix.
  - Prepare a PPT
  - Due Date: **9 am, Tuesday, 5th November**

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Mezzanine Finance in India

- **First mezzanine fund:** ICICI India Advantage Fund VII in 2008 of USD 110 mn
- KKR PE’s India arm
  - INR 650 crores in JSW Steel in 2013
  - INR 550 crores in Analjit Singh’s investment firm Max I in 2013
- Alternative Investment Fund (AIF Regulation Act 2012)
  - Private pool of funds provided by Indian and Foreign sources
  - Incorporated as trusts, LLP, and companies
  - Not regulated by SEBI
- Types of AIFs
  - **Category I, AIF:** VC Funds, SME Funds, Social Venture Funds, Infrastructure Funds
  - **Category II, AIF:** PE Funds, Buyout Funds
  - **Category III, AIF:** Hedge Funds

LBO Deal Analysis

An illustration

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Two metrics for assessing the ROI from LBO by PE Funds

- Internal Rate of Return
- Cash Return

LBO Valuation

- Two approaches
  - **Adjusted Present Value (APV):** useful in LBO by Corporate buyers
  - **LBO Model:** useful in LBO by Financial Sponsors

Steps involved in LBO model valuation…

Steps involved in LBO model valuation (1/2)

1. Current Income Statement and Balance Sheet of Target firm
2. Purchase Consideration for the target firm
3. Financing structure of the LBO: Sources and uses of funds
4. Prepare Forecasted Income Statement from current Income Statement
   - Realistic assumptions of growth rates of sales
   - Proportion of COGS and SG&A
   - New debt related interest expenses

Steps involved in LBO model valuation (2/2)

5. Prepare adjusted balance sheet and forecasted balance sheet
   - Take current balance sheet
   - Adjust the balance sheet figures with sources and uses of funds and purchase consideration
   - Forecast the adjusted balance sheet of the target firm
6. Debt repayment schedule
7. Capital structure mix: Debt and equity over forecast period
8. Return analysis: IRR and Cash Return
9. Sensitivity Analysis