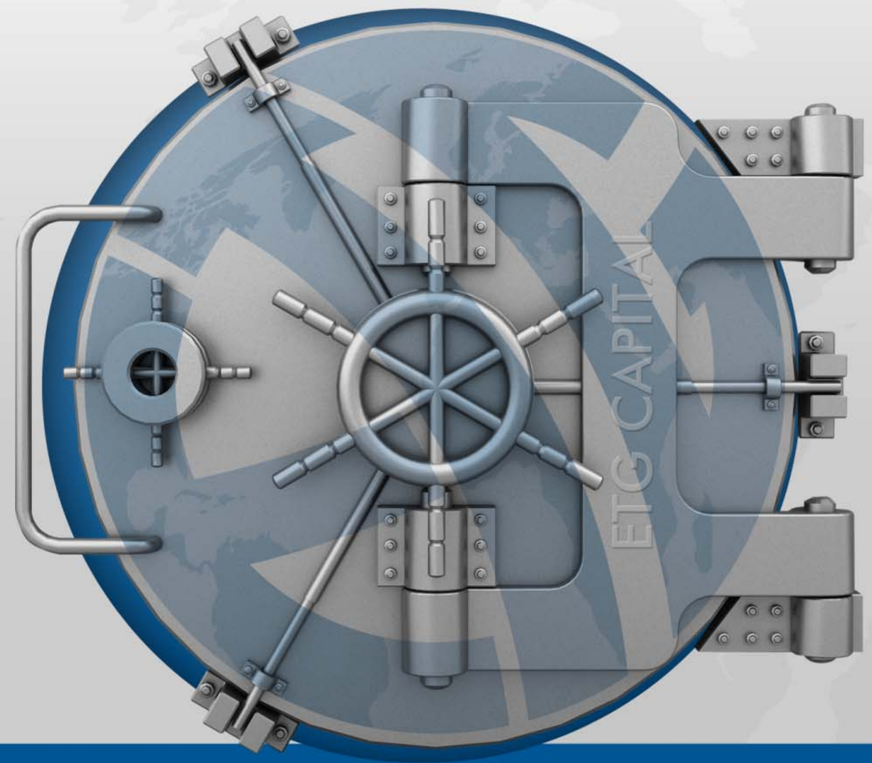
# Leveraged Buyouts (LBOs) and Private Equity-From *Boom to Bust*

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# Professional Background

- 6 years NY bankruptcy attorney
  - Skadden, Slate, Meagher & Flom and Davis Polk & Wardwell
  - Representation of debtors, lenders, vendors, bondholders in bankruptcy, insolvency, restructuring

- 5 years at Credit Suisse leveraged-finance
  - Created and managed receivables protection (put option) business.

- Since 2009, manage put option and non-cancelable, single-debtor insurance business, with a focus on protecting high-risk accounts receivable.

- Deep experience in automotive, building, chemicals, retail, consumer products, print/paper, plastics/packaging, metals, energy

# Leveraged Buyouts- The Bottom-Line

1) **Buy Low and Exit High**

2) **Use someone else's money** to:
   (i) multiply the return *or*
   (ii) to cushion the loss

# Leveraged Buy-Outs

## *A Simple Example- Buy a House*

- Buy a house / company for $100
- Minimal down payment ($20)
- Significant leverage /debt ($80)
- Cash flow (your wages / company earnings) must meet debt payments

- Over three years, mortgage / debt payments reduce principal to $75
- Over three years, value of the house / company rises to $125

- Sell company for $125
- Subtract $75 of debt
- $50 profit on $20 investment in three years

# Private Equity

**What is Private Equity**?

- An alternative investment strategy that involves investing in privately held companies.

- The key feature is the private nature of the securities purchased. Investment is **illiquid**.

- Investors invest for the long-haul; investment horizons may be as long as **5 to 10 years**.

**Partnership Structure**

- Limited partnership consist of limited partners (LP) and general partners (GP).

    - LPs are the investors, *i.e.*, the main providers of capital. These are typically wealthy individuals, endowments, pension funds, and other institutional investors.

        - Investors are typically looking for long-term capital growth, with zero or low annual dividends

    - GP is responsible for the day to day management of the partnership's investments.

- Closed-ended fund

**Compensation**

- GPs are compensated through a fixed **management fee**, as a percentage of committed capital, and profit sharing of investment gains known as carried interest, or simply, **carry**.

- While the fee and carry vary across partnerships, the 2-and-20 is a standard that many funds gravitate towards.

- 2-and-20 means that the annual management fee is 2% of the committed capital, and when final investment gains are realized, 20% of the profits go to the GP as their profit share.

# Types of Private Equity Players

Volume- lots of bets (Sun Capital) vs. few bets (KKR)

Healthy (Carlyle) vs. Distressed (Cerberus)

Management- existing (Berkshire Hathaway) vs. self-installed (Apollo)

Asset-Focus- operations vs. real-estate

Turnaround vs. Growth

Owners of other parts of capital structure?

# Leveraged Buy-Outs
## *The Basics and Advantages*

- LBOs are a way to take a public company private or transfer the ownership of a private company (from one private equity firm to another).

- LBOs are financed with **large amounts of borrowing** (*leverage*), hence the name.

- LBOs *use the **assets** or **cash flows** of the company to secure debt financing* (bonds or bank loans) to purchase the outstanding equity of the company.

- After the buyout, control of the company is concentrated in the hands of the LBO firm and management, and *there is no public stock outstanding*.

- Acquiror looks to realize its investment in **3 to 5 years** (longer now)

- Target returns are approximately 25%

**Advantages of LBOs**

- Ability to operate outside the public eye or out from under larger parent

- Alignment of management and owner interests

- Liquidity for founders/management without ceding operational or day-to-day influence

- Tax advantages associated with debt financing

# Leveraged Buy-Outs
## *Ideal Characteristics of the Target*

**Ideal Financial Characteristics**

- Strong, predictable **cash flows** to service the financing costs related to the acquisition
- Limited **working capital** and future capital requirements
- Readily **separable assets** or businesses that could be made available for sale, if necessary

**Ideal Business Characteristics**

- Strong **management team**
- **Competitive advantage** through well-known brand names, strong market share or as a low-cost producer
- Real **growth** potential
- Not subject to prolonged **cyclical swings in profitability** (a problem with commodities, maybe; long cycles help mitigate the risk)
- Products that are not subject to rapid **technological change**
- Viable **exit strategy**

# Leveraged Buy-Outs
## *Strategies*

*1) Finding cheap assets* – buying low and selling high (value arbitrage or multiple expansion)

*2) Unlocking value through restructuring*:

- Financial restructuring of balance sheet – improved combination of debt and equity
- Operational restructuring – improving operations to increase cash flows

*3) Value Creation*

- Management incentives and agency cost effects
  - Increased ownership stake may provide increased incentives for improved performance
    - Better aligns manager /shareholder interests
    - Debt puts pressure on managers to improve firm performance to avoid bankruptcy
- More efficient decision process as private firm

# Leveraged Buy-Outs
## *Capital Structure*

- Although there is no set capital structure for an LBO, it must be designed to meet the requirements of the specific situation within the constraints of the financial markets.

- Consideration is given to the company's existing and forecasted **cash flow**, its **capital expenditure** requirements, its **working capital needs** and the **investment strategy**.

- The most important objective of any capital structure is to provide a financial foundation that gives the company the ability to implement its business strategy and permits flexibility in reacting to adverse circumstances

**Secured debt** (a.k.a. bank debt, which includes bridge loans, revolving lines of credit, term loans)

The target company offers collateral for every dollar of the loan.

- It is generally the most senior debt in any firm's capital structure.

**Unsecured debt** ("junk bonds", high-yield debt", "subordinated debentures", "sub debt")

- If an acquiror needs to borrow an amount that exceeds the value of their tangible assets, it raises unsecured debt. The lender makes the loan even though the target has no collateral to pledge.
- The lender demands a higher interest rate for the added risk.

**Other**

*Discount debentures/Zero-coupon* ("zeros")- accrete for a few years, before requiring the borrower to pay interest. In other words, if the target company borrows $100 MM of zeros at 10%, it doesn't pay any interest the first year, but it owes $110 MM at the end of the year.

*PIKs*- Payment-in-Kind notes- non-cash interest payments

# Leveraged Buy-Outs
## *Exit Strategies*

1) **Sale of Company**

Liquidity: High

*Considerations*

Existence of strategic buyers

Financial buyer valuations are lower

Limited buyer universe for large companies

2) **Recapitalization**

Liquidity: Moderate

*Considerations*

Constraints of existing debt

Continued ownership

3) **Public Offering**

Liquidity: Moderate

*Considerations*

Dependent on equity market (Valuation, Degree of liquidity)

Low receptivity to cashouts

Not available for all types of businesses

# Leveraged Buy-Outs
## *Risks*

- Rising interest rates
- Higher asset valuation - overpayment
- More regulation of industry
- Economic slowdown
- Failure of exit strategy
  - - Boom to bust…are the markets (equity and/or debt) open for exit (IPO, Recap, Sale to financial buyer)

# NOT a credit manager, BUT a fixed-income portfolio manager; AN INVESTOR

- The proper way to look at receivables…..like a fixed-income investor (“$1 of product shipped is $1 loaned”)
  - *Difference*: relationship to the borrower

- **Always be thinking: “**What is a reasonable “return” on our investment”
  - Constantly changing risk profiles
  - While considering long-term relationship with customer

# Risk/Reward Balance

- Achieving the appropriate risk/reward balance

  - Looking to the market for guidance- unsecured debt, comparables, etc.

    - **Example**: Feb. '09; Ford
      - Automotive-parts suppliers to ***Ford*** earning 2.5% net-profit per shipment (60 day terms; *effective yield of 15%).*
      - Ford debt yielding 20+%.
      - Better investment to send all employees home and invest in Ford bonds!

# Risk/Reward Balance

- Which portfolio is better?

| | Portfolio 1 | Portfolio 2 |
|---|---|---|
| Sales | $15mm | $20mm |
| Margin | 12% | 16% |
| Profit | $1.8mm | $3.2mm |
| Average Credit Spread | 500bps | 1200bps |
| Risk-adjusted Margin | 7% | 4% |
| Risk-adjusted profit | $1.05mm | $0.8mm |
| | WINNER | LOSER |
| | | |

# High Risk- what to look for

- Don’t wait until days-payable (*i.e.* days receivable from your customer) starts to trend upward.
    - Said another way, “everyone pays- until they don’t”

    - Important Data Points
        - ***Leverage- covenants; as it relates to default and recovery
        - Cash-Flow- CapEx, interest expense
        - ***Liquidity- borrow, asset sales, other sources
        - Large important events (debt maturity, lawsuit, one-time capital expenditures)
        - Drastic CapEx cut-back, especially in retail and manufacturing

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