Leveraged buyout model

Economics, Tax

Introduction

The leveraged buyout phenomenon has been subject of many studies by a number of financial theorists, which have attempted to give an explanation of this trend during the 1980s, evaluating historic and financial aspects of that poque and previous. In this essay, we will see at those different panoramas and aspects that took companies to accomplish a wave of corporate restructuring during the 1980s and why these factors enhanced the use ofLeveraged Buyouts. In addition will se the diverse features companies must have in order to be a leveraged buyout target and the consequences after the buyout is accomplish in order to reach a better level of efficiency with and obvious benefit in capital gain for its investors.

The Boom in Leveraged Buyouts (LBOS) During 80s

What Is ALBO

The leveraged buyout is a form of corporate restructuring which had its most important period during the 1980s. The essential characteristic of LBOs is the high level of debt is incurred in order to unify and reduce the ownership to achieve a superior point of efficiency and profits maximization. This dramatic increase in debt ratios, according to Hite & Owers (1996), can go from 1 to 10.

ALBO according to Brealey & Myers (2003) varies in two main ways from the normal acquisition process. First, the purchase of the stock is debt financed or at least a substantial portion, some often the debt used in this type of restructuring is debt below investment grade or also denominate Junk Bonds.

Second, the LBO goes private and its shares do not trade longer on the open market.

This reduction and unification in ownership, brings itself a number of repercussions in the managerial level and the company's structure.

Historical, Economic and Financial Factors

According to Weston & Johnson (2001), the leveraged activity can be divided in three important periods, the 1980s, the early 1990s and the post-1992. The leveraged activity comes from not just the 1980s decade, but from previously period of highly leveraged transactions during the 1970s.

The economy'shealthand expansion during the 1980s until 1992, was a key factor of the increase in Merger and Acquisition transaction. According to Weston & Johnson (2001), previous boosts had followed similar patters of economy welfare in restructuring activity. M&A and divestiture transactions had its highest activity during 1986, meanwhile 1988 was the top for LBOs transactions.

One economic factor involved in this LBOs wave, was the constant increase in inflation during the late 1960s to 1982. This factor causes a drop in the q-ratio levels from 1. 3 in 1965 to 0. 58 in 1982. This ratio measures the market value of a firm to the replacement cost of its assets (Weston & Johnson 2001). Therefore during 1981, is given the opportunity to buy cheaper capacity in the financial market rather than in the real assets market because of the q-ratio. Therefore, the value of a company in the financial markets would drop to about half price of its cost to replace the firm's assets.

Clearly, this gave the facility to buy firms in the financial market at half price of its replacement assets value. This obviously generated a wave of hostile takeovers.

In the same way, the constant increase in inflation brought during this period, the facility to make tax savings by means of recapitalization. (Weston & Johnson 2001) The debt payments were not adjusted for inflation and this coincided with an increase in price levels. This meant that the amount of debt payments decreased in terms of the percentage of the company's equity during this period of constant inflation. Therefore, these circumstances created an opportunity for externals investors who might be interested in increase the level of companies' debt in order to make higher tax shields and thus, take advantage of this " tax benefit".

As a result of these tax savings and the increase in price levels, companies were having the benefit of great amount of freemoney. This benefit created the propitious room for the problem outlined by Jensen-Meckling, the Principal - Agent dilemma. This is because the managers will spend the free cash flows in non-beneficial expenditures of for personal benefits rather than profitable investments that represent an improvement in the shareholders' value.

All these factors according to Weston & Johnson (2001), motivated investors to look at those companies with a low leveraged level and with a great amount of free cash, as a target of their desire of restructuring. In addition, this also brought new variety of debt financing. For instance, high yield

bonds, very well known as " Junk Bonds" that in someway were responsible for this Leveragedrestructuring wave.

Legislative Factors

A number of legislative factors played a significant role in LBOS wave during the 1980s (Weston & Johnson 2001). For example, the Economic Recovery Tax Act (ERTA) enacted in 1981 under Reagan's Government, in which were reduced marginal taxes to generate a growth in the economy. This reform pursued the same aims of growth and economic activation that preceding reforms during the 1920s and 1960s.

This reform gave to companies and individuals a range of tax breaks such as, global reduction in personal income tax rates, corporate tax breaks, led by a new system of depreciation that produced negative effective tax rates on the profits from new investments, tax breaks for individuals with savings. (Freze 1996)

Also according to the description of Freze (1996), critics at that time argued that ERTA would be a good deal to the rich because their tax payment would fall. Effectively critics were right and estimators of ERTA shown falling tax payments by upper income taxpayers, this allowing to rich people to enjoy great savings in taxes.

Another important reform during this period was the implementation of ESOP Employee Stock Ownership Plans. These ESOPs, has been the medium by which have been carried out many buyouts. Therefore, ERTA increase the facility of ESOPs to borrow from a bank in order to invest the money in the company's shares. According to Kensinger & Martin (1996), through this

concept, companies were able to eradicate income tax and make for entire disposition of the company the cash flows before tax. In addition, Kensinger & Martin (1996) say, that under the tax laws, at the time their article was released, these laws encouraged to take away the money from the firm rather than keep it to reinvest.

The Antitrust Climate which has been well establish during the 1950s to the early 1970s against horizontal and vertical merges, started to change with the Reagan's liberalism policies (Bittlingmayer 2002). These policies included move the Department of Justice and the Federal Trade Commission in a new and more liberal direction.

In 1982, the Department of justice produced the " Merger Guidelines" in which explicitly reduce the strict measures against horizontal and vertical merges. According to Bittlingmayer (2002), this new address in policies in the early 1980s produced clear result in the increase of Merger activity.

These explanations about the changes in antitrust policies during the 1980s by Bittlingmayer are accorded to the statements of Weston & Johnson (2001), in which they set up, three different explanations for the changes in antitrust policy. First, are the political views of the new administration. Second, the support of academics' findings for a dynamic competition between large firms. Third, the foreign competition the USA market was facing at that time.

Therefore, themotivationof the wave of corporate restructuring including Merges, LBOS, ESOPs, MBOS, during the 1980s, had a basis in the combination of all these variety of factors, which allowed such activity.

The Characteristics of Leverage Buyouts (LBOs)

Leverage Buyout Process

Divest decision

This divest decision is reached when is identified for an external group a strategic division with a high range of opportunities, or when the management has identify a low performance division, which is not adding value to the total structure of the conglomerate.

Purchase of the division - by division's manager

The division's management or the external buyer can see that because the division does not belong to the conglomerate business core, this has not been paid enough attention by the conglomerate's management. Therefore, the division's management or the external buyer, have foreseen a bright future for the division on its own and decide to buyout. Hence, conglomerate's management and the interested counterpart establish the investment banks to evaluate the possibility of a LBO financing.

Financial Analysis

This analysis is carried out to know if the division on its own is able to meet the debt payment. Therefore is looked at the division's book value of assets, the replacement value of assets and the Liquidation value of the assets in

order to calculate the value of the division, and to establish what lenders might receive in case of any adverse situation.

Division' purchase price

The conglomerate's management establish the division's price above the liquidation value of the assets. During the 1980s, this resulted in a truly fight between external bidders, because the price was set up just above the liquidation value of the assets in consideration with the division's workers or management in an ESOP or MBO. Therefore, this generated a fierce external competition for a number of divisions.

Investment by the division's management

After being determinate the division's price, the division's management determinate the amount of capital would they invest in the acquisition. This is important for lenders as it might indicate the commitment managers have with the performance of the division.

Conformation of the Lending Group

At this point are organized the main lenders, who will provide the capital to accomplish the LBO. This lending group or LBO funds, might be conformed by a number of lenders in order to spread the risk. The number of lenders depends of the size of the transaction. In addition, if the transaction is carried out by the division's management without o with a low participation of the third-party equity, the transaction is called " Management Buyout".

External Equity investment

In this step is evaluated whether or not are necessary external investors. The amount of external investment is determinate if is not possible obtain all the capital from banks and LBO funds. Also might be necessary in order to glad principal lenders to spread more the risk. Some transactions might not need external investment.

Cash flow analysis

Despite have been carried out a previous financial analysis, at this point is evaluated is the division's cash flows will be enough to cover the debt payments. This result in an expenditure reduction, restriction of budget and in some cases a totally restructuring of the deal, this in order to achieve the interest payment on the debt.

Financing is agreed

After reorganizing the engaged cash flows, and make them enough to pay debt, the deal is accomplished.

Characteristics of a Company to Be ALBO Target

There are a number of features making attractive a company to be a LBO target (Gaughan 1996). For instance Stable cash flows, in order to predict the rapidly debt pay-off. A good and stable Management group, this because lenders would feel more secure about lending money to someone reliable. Room for significant cost reduction, for e. g. down sizing, cut in non-central expenditures. Equity interest of owners, the more capital and participation the owners and managers have within the company, the more secure

lenders can feel about to lend them money. Ability to cut costs, this refers to the skills of the management to reduce costs from wasteful areas without hurting the company's future plans. Limited debt on Balance sheet, this because the company is going to suffer an immersion in debt, which might result in an inability to meet interest payments if the level were high. Separable non-core business, this aspect is related with the ability to cut costs and since the company could incur in selling inefficient assets to reduce the amount of debt.

Forms of Financing ALBO

There are two main classes of debt that are used in a LBO transaction: secured and unsecured debt (Gaughan 1996). The secured or senior debt could be grant by a Bank, Insurance Companies or Venture capital firms. In addition, Weston & Johnson (2001) say that around half or more of the debt incurred in a LOB is secured by the assets of the acquired firm or based on the future cash flows.

The unsecured or subordinate debt, is issued by the company in private places or in form of highyield bonds very well knows as " Junk Bonds" and classified for Standard & Poor like BBB or below (Below investment grade). This issued of high-yield bonds was an easy way to acquire financing from public sources. Besides these bonds do not enjoy of a secured panorama, they holders have the benefit of higher rates of return.

Because the facility to achieve financing through the " Junk Bonds", those become to play an important function in the Takeover activity (Weston & Johnson 2001). In addition, these bonds have facilitated the growth of many

high-risk companies, but also increased the collapse of many firms in the late 1980s.

Changes in Organizational Structure

One of the changes managers have to face in a LBO is that they have to deal with a small number of shareholders. This results in a more closely monitoring relationship of the manager's actions.

The small number of shareholders holding the purchased stock is denominated a partnership of investors. Among the new shareholders, we can find the previous management line with as substantial share of the company and a third party-equity denominated the buyout specialist. This buyout specialist plays an important role within the new corporate structure as a major shareholder, guarding the fulfilment of the contracts acquired with lenders, monitoring and taking the need measures to improve efficiency and make profitable the company.

Why Are LBOS Attractive

The large abnormal gains from make simpler a complicate forms of conglomerate, the concentration of the decision making process and the implantation of new incentive schemes for managers, together with theresponsibilityto keep a good stock price performance within the financial markets, are according to Kensinger & Martin (1996), some of the reasons to make attractive LBOS.

In addition, LBOs are attractive because they are a good deal for previous shareholders, as they receive an abnormal gains or a premium over the company's market value. This situation reactive the economy, as the prior

shareholders have money to reinvest their capital gains in any high rate opportunity in the market (Kensinger & Martin 1996).

After accomplished a LBO restructuring, the company goes through a number of changes. For Instance, the buyout specialist goes to carry out a series of adjustment and correctives in order to maximize efficiency and profitability. The management line has higher commitment incentives with the company due to the new position and participation they have in the ownership structure.

Despite the capital gains of current shareholders, one factor of motivation for the acquiring shareholders is to obtain capital gains after a period between 3 to 5 years, when the LBO goes public again in a SIPO (Second initial public offering) or is sold to another private firm.
Beside the historical and financial reasons and the appropriate ground LBOs had during the 1980s. This kind of corporate restructuring was itself a good way for individuals, financial corporations and others investors to make money. As Breadly & Meyer (2003) say, LBOs are a " Diet Deal". Therefore, many external bidders are interested in those companies because of the concentration of the resources and effort offered by the whole participants in the restructuring.

Another good attractive reason for investors is that the cash flows are tied to the interest payment on debt. As we saw before in the LBO process, the company's cash flow is reduced or calculated in order to cover the standard costs and the interest payments. Therefore, this situation reduces the

manager's mobility in the investment decision, which overcome the dilemma Principal-Agent, since it is almost avoided the wasteful investment.

The tax benefits also account among the attractive factors, as we said before, the ERTA allowed to individual and firms to make significant saving in tax payments, which result in an explosion of free cash to invest and to save through tax shields.

A Leveraged restructuring is also a mechanism of defence; a company can adopt in order to preserve its ownership against a hostile takeover. On the other hand, when a " friendly" LBO restructuring is announced the company becomes a takeover target for investors or firms eager to put their money in that LBO opportunity.

As another component of attractiveness of LBOS is the efficiency factor, this is more visible because is derived from the drastic changes within the organization. The firm is more focus in its own activity, managers and workers are highly motivated and more devoted with the performance of the company, due to their capital participation, the closer monitoring and the debt pressure.

Remind LBOs Desirables in Today's Economy

The changes in the actual panorama and in the period after LBOs Boom, has suffered key alterations. For example, during the late 1980s the new president G. Bush started again with a fierce policy antitrust. This provoked that many cases of merges were failed against the firms involved in the transaction. Also the Tax reform carried out by Bill Clinton during 1993, in

which the tax rates were raised and tax corporate benefits were stopped, generating an uncertainty panorama to companies (Freze 1996) & (Bittlingmayer 2002).

The bad experiences during the late 1980s in some of LBOs had a basis in the overpriced and poorly analysis the investors and lenders did of many companies. In addition, the unsecured debt displaced the secured debt in a high percentage within the funding LBOs transaction. These reforms and bad experiences match the collapse in popularity of LBOs activity in the late 1980s and the early 1990s.

Besides the drop of the LBO activity during the 1990s, this kind of restructuring has been one of the most successful ways in corporate restructuring (Stern & Stewart 1998). However, the high level of debt has not to be the stimulus to have an efficient and profitable company in order to create value.

Nowadays, the LBO activity has gone from the well establish enterprises to a High-growth, technology-driven industries (Weston & Johnson 2001). However as it was said before the high level of debt are not desirable for any financial structure in any company. Therefore, companies have to create new ways to produce the same effect the LBOS wave did, as far as increase the productivity and efficiency, and avoiding wasteful investment and the Principal-Agent Problem.

In addition, the " new" forms and facilities for financing projects in today's economy have played an important role in the ways companies are

restructuring to develop high standards of efficiency. As Kensinger & Martin (1996), describe the endless variety of ways to financing any kind of business. For instance, venture capital and business incubators are ready to invest in the entrepreneur sector. The mezzanine loans, joint ventures, project financing and public offering are mediums to invest in high technology projects. Financial corporations and a wide range of financial packages for Large and establish companies.

Thus, These new form of financing combine with the need to create new ways to incentive management, has created the new EVA. This is a System based in a performance measure, in simple words; the EVA measures the profitability of the investment done by shareholders in a company, against any other equity opportunity in the market.

As Breadley & Meyer set in their book, " A perfect System of corporate governance would give managers all rights incentives to make value-maximizing investment and financing decision". Therefore the EVA, look for incentives a good manager performance in order to guarantee that the cash will be paid out to investor after a run out of positives NPV projects instead of wasteful investment, managers perquisites or private benefit.

Therefore, in today's economy the LBO activity is still playing an important role as a dramatic way of corporate restructuring. However the more desirable part of LOBs are its effects in efficiency, productivity, avoiding the managers and Shareholders problem and the final result of changes in positives capital gains for shareholders.