The balance between debt and added value

Leveraged buyouts, whereby purchasers use significant debt to fund transactions, are growing in size and influence. Colin Blaydon and Fred Wainwright explore the rise of private equity.

The leveraged buyout (LBO) model has evolved into a powerful mechanism for corporate transformation. Multibillion-dollar buyout funds are busy purchasing private companies and taking public companies private. Nine of the top ten largest buyouts in history have been completed in the past 18 months by private equity houses, and with these record amounts of capital, both in terms of debt and equity, available, megaloads are almost commonplace.

This article will survey the basics of buyout transactions, discuss how value is created and describe current industry issues. Recent developments include club deals, technology buyouts, the high levels of credit currently available and the institutionalisation of the industry.

What is an LBO?

An LBO is the purchase of a company or division of a company using significant debt, whereby the target company’s cash flows are used to support the loan payments. Integral to the alignment of incentives is management participation in the equity of the new company, usually a combination of personal cash investment and stock option compensation. Debt can be in the form of traditional bank financing, bond offerings, seller financing and loans from specialised funds.

According to data collected by Thomson Financial and the National Venture Capital Association, in the US, the buyout industry is expected to raise over $100bn in 2006 and top multibillion-dollar buyout funds are busy purchasing private companies and taking public companies private. The earliest LBOs were based on the idea that some companies with hard assets and steady cash flows could be financed in a manner similar to real estate. Real estate transactions

Value arbitrage

The new reality of public markets is that many good companies are ignored by the relatively slimmed down analyst groups of major financial institutions. Even before a series of recent corporate scandals spawned a wave of new corporate regulation that affected investment banks, there were many publicly traded companies that were poor at marketing themselves to investors.

By contrast, buyout funds are experts at knowing when and how to communicate with various constituencies of a business, from employees and shareholders to potential lenders and buyers. This is not just window dressing; an LBO, adjustments need to be made to the management team or new markets found for a product. What is surprising is how often the changes are minimal but the resulting increase in valuation, whether through an IPO after taking a company private or through a sale to a strategic buyer, is substantial. In addition, sectors suffer from the cyclical nature of supply commodity prices or other macroeconomic trends as well as investor fads. Good companies can be caught in these downdrafts of investor sentiment, which create opportunities for buyout funds to help management make adjustments to the company in private and then relaunch with an IPO when the sector is in better favour.

Major corporations periodically expand their range of products and operating divisions then slim down and sell off non-core assets. Buyout groups stand ready to sell their fund’s portfolio companies when major corporations are buying. Conversely, when corporations are selling divisions, the buyout funds are willing to take the risk of helping the divisions develop their own internal operating structures and external market positioning.

Today, sophisticated sellers and their advisers are aware of the value increase that private equity acquirers are anticipating. Therefore, sales are frequently achieved through auctions or multiple bilateral negotiations, and relatively few are unilateral proprietary or multiple bilateral negotiations, and relatively few are unilateral proprietary. The new reality of public markets is that many good companies are ignored by the relatively slimmed down analyst groups of major financial institutions.

Recapitalising to add value

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have long been financed with sub-
stantial amounts of debt because
interests in the physical assets and
relatively steady rents.

The first LBO practitioners realised
that many companies could be lever-
aged but had historically carried little
debt. The companies were valued
based on an expectation that they
would pay down to low amounts of
debt, so buyout houses could pay a
premium for two reasons: they were
only using relatively small amounts
of debt to back equity investments
(the rest of the purchase price was
paid via debt), and the interest pay-
ment of such debt was tax deductible.

In fact, the latter point enables the
creation of tax shields that add value
to the enterprise. This is well known
to financiers who understand that
the value of a company can be
equated as the value of the company
financial statements and the value of
any future interest tax shields
created by adding debt to the capital
structure. Of course, there is a limit
to this strategy because the introduc-
tion of financial risk due to signifi-
cantly higher debt can result in issues
related to equity dilution that can
offset the value of the tax shields.

Today, sophisticated restructuring
of the balance sheet is commonly prac-
ticed by large private equity houses,
investment banking advisers, and
lenders to provide capital in highly
volatile industries. However, the need
for sophisticated restructuring is no
longer an approach that is commonly
seen as the primary value adder
because the introduction of leverage
create the necessary clout to
рабочих мест и затем продать компа-
нии, и увеличить выручку.

Однако, есть некоторые риски,
связанные с высоким риском
для должников. Например, могут
быть проблемы с уплатой налогов,
которые после уплаты процентов
по кредитам могут быть непоко-
ливны. Кроме того, могут возникать
проблемы с обслуживанием кредитов
и выплатой процентов. Поэтому
необходимо быть осторожными и
внимательными при использовании
кредитов для финансирования
активов.

Вопросы, которые нужно
уважать:

1. Определите риски и возможности
когда используют кредиты для финансирования
активов.

2. Какие риски и возможности могут возникнуть,
когда используют кредиты для финансирования
активов?

3. Какие риски и возможности могут возникнуть,
когда используют кредиты для финансирования
активов?