

## Review

# Leveraged buyout analysis

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**This paper provides information in regard to the nature of the leveraged buyout and indicates the positive and negative results of the leveraged buyout operation. To help the better understanding, the author has made the comparative study in respect of UK, USA, and India. Also, this paper has analyzed the mechanism of leveraged buyout by giving the case studies of various leveraged buyouts to value the performance of leveraged buyout accordingly.**

**Key words:** Leveraged buyout, equity, debt, acquisition, management, structure.

## INTRODUCTION

*There may still be time to at least ameliorate what could be the next financial meltdown. But, as the story notes, four of the last eight Treasury Secretaries — across party lines — have background in “private equity firms.”- Socratic Gadfly*

Leveraged Buyout has become a popular vehicle for business acquisition especially among the private equity firms, management buy-out groups and other "going private" sponsors. Thus this is the new innovation of the way for the investors to invest even though they may not have the huge amount of equity for the acquisition. An leveraged buyout (LBO) is the acquisition of a target company by an investor group, which typically includes the target's own management. The investor group takes control of the target's finances the acquisition w/ minimal equity capital from LBO 'sponsors' or equity investors. The primary form of financing is debt collateralized with the assets of the target itself or with its cash flow.

In many countries like U.S.A., England in European Union or country in Asia like India also have applied such investment way to acquire another target company. There are many recorded examples of such huge transaction which make the introduction of leveraged buyout to more investors to come and invest by such route.

Although the investment through leveraged buyout may give the benefit to the investors to invest with a small equity, however, there are also risky in respect of the failure of the repayment of the borrowing loan. The investors expect to return the money from the cash flow

of the acquired company but the business of the company may not be run in profit. Then the chain of the business collude will take place not only with the acquired company buy also the bank which has lent the money for such investment.

Hence the investors in such leveraged buyout transaction should have the sufficient equity stability. The experience of the investors is also one important factor for the investor to know how to run the business like management buyout which the insider management team will run such investment. They know the nature of business so they can improve the business contrasting to the management buy in which the business will be run by the outsider investors. They may not have the knowledge on the nature of the business that much.

## WHAT LEVERAGED BUYOUT IS

During the 1980s, leveraged buyout (LBO) became increasingly common and increased substantially in size. Jensen (1989) predicted that the leveraged buyout organizations would eventually become the dominant corporate organizational form. A leveraged buyout is essentially a strategy involving the acquisition of another company using a significant amount of borrowed money, bonds or loans, to meet the cost of acquisition. There is usually a ratio of 70% debt to 30% equity. The assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The new owner would gain control with a small amount of

invested capital because he or she is able to secure a large loan for the balance of the amount needed. Leveraged Buyout – also called as ‘Highly-Leveraged Transaction (HLT)’ or “bootstrap” transaction<sup>i</sup>. A leveraged balance sheet has a small portion of equity capital and therefore a large portion of loan capital<sup>ii</sup>. Consequently the debt will appear on the acquired company’s balance sheet and the acquired company’s free cash flow<sup>iii</sup> will be used to repay the debt. The leveraged buyouts nowadays call themselves as private equity firms.

The purpose of leveraged buyout<sup>iv</sup> is to allow companies to make large acquisitions without having to commit a lot of capital. It may be easier to compare the leveraged buyout transaction with the rental of the house which you need to mortgage. Just as a mortgage is secured by the value of the house being purchased, some portion of the debt incurred in an LBO is secured by the assets of the acquired business. The cash flow which is coming from the rental of the house will be paid for the mortgage like the cash flow from the target company which will be paid for the loan taken for the LBO.

The first LBO may have been the purchase by McLean Industries, Inc. of Waterman Steamship Corporation in May 1955. In Mc Lean Industries, Inc case McLean borrowed \$42 million and raised an additional \$7 million through issue of preferred stock. When the deal closed, \$20 million of Waterman cash and assets were used to retire \$20 million of the loan debt. The newly-elected board of Waterman then voted to pay an immediate dividend of \$25 million to McLean Industries (Levinson, 2006).

## LEVERAGED BUYOUT PROCESS

### Stock format

LBO is usually done through the stock or asset purchase format. In the former, target shareholders simply sell their stock and all interest in the target company to the buying group and then the two firms may be merged. In the asset purchase format, the target firm sells its assets to the buying group. After the buyout the acquired company is run as a privately held company for a few years after which the resale of the firm is anticipated. This buying group may be sponsored by buyout specialists or investment bankers that arrange such deals and usually includes representation by the incumbent management.

Buyers of the firm targeted to become an LBO often consist of managers from the firm being acquired. The LBO initiated by the target firm's incumbent management is called a management buyout (MBO). The buying group often forms a shell corporation to act as the legal entity making the acquisition. An MBO or LBO is a defensive measure against takeover. Investors in LBOs are referred

to as financial buyers who hold their investments for five-seven years. LBOs are designed to force change in mature business and are a healthy way to create value where control of companies is advocated to promote efficiency. They can improve operating performance by restoring strong constructive relationships among the owners, managers and other corporate stockholders.

### Private equity

Kavaljit (2008) had said that private equity is a broad term means any investment in assets or companies that are not listed on public stock exchanges. Shares are bought, sold and issued privately. Leveraged buyout is one of the types of private equity which the company will use its own equity to acquire another company including the debt from the bank.

Private equity investors of course need an exit route, generally over a three to five-year time span. The exit may come through divestment in a public issue or sometimes by sale to another private equity or strategic investor. Several Indian companies' acquisitions abroad have comprised purchases from private equity investor. Private equity funds are typically limited liability partnerships. The fund manager secures commitments to invest from outside parties like institutional investors such as banks and insurance companies, university endowments, pension funds and wealthy individuals, to invest in the fund.

## CLASSIFICATIONS OF LEVERAGED BUYOUTS

### Management buyouts (MBOs)

The Hindu Business line on Thursday, July 10, 2008 had stated a management buy-out (MBO) usually involves the acquisition of a divested division or subsidiary or of a private family owned firm by a new company in which the existing management takes a substantial proportion of the equity. Such acquisitions take place when owners desire to sell off a division or a company or even close or liquidate it, while the managers on the other hand envision future growth potential and are willing to place their bets on improving the performance of the division or company by acquiring it. Since managers may not possess adequate resources to effect such an acquisition, they are often compelled to seek financing or even a strategic partnership for this purpose. In place of the LBO association, MBOs usually require the support of a private equity firm.

Managers may not be able to finance the MBO transaction by themselves due to having only the small sum of money. Thus they can only acquire the small stake in the target while the majority of the stake of the transaction will be taken by the private equity who may

be the partner with the managers. Thereafter the business will be running by the new team of management (Management Buyouts, 2008).

In many instances, board approval and shareholder votes are required before the acquisition can be consummated. However, the buyout group may bypass the board and possibly the voting process by making the tender offer. If it is successful, the buyout group may be able to cash out remaining shareholders without their consent.

Mike Wright, Michael Jensen, Douglas Cumming and Donald Siegel found that MBO plants were significantly less productive than comparable plants before the transfer of ownership but they experienced a substantial increase in total factor productivity that is, assets and labor after a buyout of up to 90%. The results imply that the improvement in economic performance is at least partially due to measures undertaken by new owners or managers to reduce the labor intensity of production, through the outsourcing of intermediate goods and materials (Wright et al., 2007).

The structure must provide new equity investors with an acceptable rate of return and give the acquired company enough financial flexibility to pursue its growth objectives and service debt. It is important that the capital structure fully considers the interest of all parties concerned, including the employees, selling shareholders, and the management and perhaps most importantly, that the structure is in the best interest of the business itself.

## CONFLICTS OF INTEREST BETWEEN THE DIRECTORS AND THE SHAREHOLDERS

The matter of fiduciary obligation is very important in the buyouts especially in the management which the part of the acquisition will be taken by the existing management of the target company. The issue has come whether the interest of the shareholders of such target company will be affected by the management buyouts or not. The responsibility of the management team for the shareholders is to protect the interest of them. Therefore, the team has to come up with the best directions to achieve the interest protection duty. As the management team of the company having the fiduciary duty, they have to give the best and highest price as possible.

However, as the member of the buyout team, they obviously would like to push the price as low as possible. A low price makes the purchase more attractive and enhances the potential future gains from going public again. So from this point the conflict of interest between the management team and the shareholders will come up. Although the price of share may be fair, the shareholder's confidence on the management will be lack. The management is the insider people who have the competence knowledge of the company. They know

better than outsider how to constitute the stability of the company again. They may try their best for that but the lack of confidence on them may be the obstacles for the management.

Traditionally under the corporate opportunity doctrine, the law has prohibited the officers, directors, and senior managers from the taking personal advantage of opportunities that come to them in their official capacities and are of potential benefit to the corporation (Brudney and Clark, 1981)<sup>v</sup>. The classic legal statement of the responsibility of corporate fiduciaries is found in the well known case of *Guth v. Loft* decided by the Supreme Court of Delaware in 1939<sup>vi</sup>.

Another important case which deals not only with the fiduciary duty of the directors but also the financial assistance is *Belmont Financial Corporation v. Williams Furniture Ltd*. In this case the directors had made the conspiracy to give the unlawful financial assistance to buy the share of its own company. The directors at the same time had the fiduciary duty by being the trustee of the fund of the company. The directors of the company have to exercise such fund in the way which will not affect the benefits or interest of the company.

Nevertheless the management buyouts transaction through the management team of the existing team is also the benefit for the shareholders. The insider managers know how to deal with the transaction and protect the interest of the company as well as the shareholders. From this the shareholders may be willing the insider managers rather than the outsiders to rejuvenate the company<sup>vii</sup>.

## Management buy-ins (MBIs)

A management buy-in (MBI) (Robbie and Wright, 1990) is simply an MBO in which the leading members of the management team are outsiders. Although superficially similar to MBOs, MBIs carry greater risks as incoming management do not have the benefits of the insiders' knowledge of the operation of the business. Venture capitalists have sought to address this problem by putting together hybrid buy-in/management buy-outs (so-called BIMBOs) to obtain the benefits of the entrepreneurial expertise of the outside managers and the intimate internal knowledge of the incumbent management. The advantages of MBI are there is a wider chance for others who have the better credit than the existing management team in MBO which can obstruct the other potential buyers to buy the share in the better price. Also the new management team may have the better contacts and reputation for the backing. However at the same time there are some disadvantages in MBI also. The new management team may not have the knowledge about the business; they are not familiar with internal working to be acquired. So they may be considered as the riskier which make the difficulty for the backing. So a compromise between MBO and MBI combining some of

the benefits from them may be achieved by a buy-in management buy-out (BIMBO), which combines new and old management.

### **Buy-in management buy-out (BIMBO)**

A buy-in management buy-out is a compromise between a MBO and a MBI. The existing management are largely retained, joined by some key new managers, and both take an equity interest in the company, usually with private equity funding.

The features of BIMBO are: 1.) it retains the continuity management like MBO but also bring the new management who may have the better credit or position to raise funding like in the case of MBI. 2.) it may cause some uncertainties for the management but it is less than in the case of MBO. 3.) it may improve the quality of management like MBI. 4.) it is less risky than MBI.

However this does mean that BIMBO will always be preferable to a MBO or a MBI. For example, if the existing management is able to raise enough funding to match other likely offers, then an MBO would be more straightforward. On the other hand, if a complete change of management is needed, then MBI would be preferable.

### **Institutional buyouts (IBOs)**

Investor-led buy-outs (IBOs) involve the acquisition of a whole company or a division of a larger group in a transaction led by a private equity firm and is also referred to as bought deals or financial purchases. The private equity firm will typically either retain existing management to run the company or bring in new management to do so, or employ some combination of internal and external management. Incumbent management may or may not receive a direct equity stake or may receive stock options. IBOs developed in the late 1990s when private equity firms were searching for attractive deals in an increasingly competitive market and where corporate vendors or large divisions were seeking to sell them through auctions rather than giving preference to incumbent managers. These deals have similarities with LBOs.

The differences can be summarized in terms of the metamorphosis of LBO Associations into private equity firms as the industry has developed. As the names suggest, IBOs tend to have lower leverage than LBOs and may be expected to create value through developing the company not just through efficiency improvements.

## **POSITION OF LEVERAGED BUYOUTS IN EU, USA, AND INDIA**

### **Position of leveraged buyout in EU**

In 2006 the Banking Supervision Committee has

Leveraged Buyout activity in EU has significantly increased even though banks' direct investment exposures to LBO funds were not found to be substantial (European Central Bank Euro System, 2007). The survey established that many banks earn significant income from the investment, fees and commissions derived from LBO-related activities. Bank has played the important role in supporting the rapid pace of growth of EU private equity market such as debt financing syndication and creation of innovative debt structures have made bank necessary intermediaries in the EU leveraged buyouts market.

Leveraged buyouts are among the activities carried out by private equity companies. Private equity (PE) can be defined as medium to long-term equity financing of unquoted companies, or financing of the equity tranche of buyouts of public companies. The PE market has become an important source of funds in developed countries' corporate finance markets<sup>viii</sup>.

Within the EU, LBO funds and fund managers exist in a variety of legal forms. The particular choice of structure of a fund depends on the location and tax concerns of the fund managers and their prospective investors, as well as the relative benefits provided by the different legal and regulatory regimes that operate in different jurisdictions. Partly due to the fact that LBO firms often need to raise large amounts of capital, most large LBO funds are in practice domiciled in jurisdictions that allow for limited partnerships.

At the first step of partnership the general partners who have the limited liabilities for the debt and obligations of the LBO partnership will invest the substantial amounts of their own funds in the partnership. General partners are responsible for both undertaking investments and participating in the management of the target company<sup>ix</sup>. The huge amounts of equity capital is collected from the limited partners such as institutional investors, pension funds, insurance companies, hedge funds, and banks which commit to providing around 95 to 97% of the total funds raised by the partnership. Committed equity capital is subsequently pooled and normally it has to be invested in target companies and businesses by general partners within a given time frame.

Debt providers for LBO transactions are typically banks which may, but often do not, also invest equity in the same LBO partnerships as limited partners. It generally includes some or all of the following elements: Senior loans<sup>x</sup>, consisting of revolving facilities and senior loan tranches A, B and C, second lien loans<sup>xi</sup>, mezzanine loans<sup>xii</sup>, high-yield bonds<sup>xiii</sup> and payment-in-kind (PIK) notes<sup>xiv</sup>.

## **POSITION OF LEVERAGED BUYOUT IN USA**

A private equity-sponsored LBO generally is defined as an investment by a private equity fund in a public or private company (or division of a company) for majority or complete ownership. In U.S.A., the American Research

and Development Corporation was the first private equity firm which was formed in 1946 by George Dorios to encourage the private sector investments in businesses run by soldier returning from the Second World War.

And the deal which made the leveraged buyouts boomed in U.S. was leveraged buyouts of RJR Nabisco by Kolberg Kravis and Roberts in 1989. The company was in auction with two bidders: F. Ross Johnson the company's president and CEO, and Kohlberg Kravis Roberts, a private equity partnership. The company eventually was sold to KKR. It was \$25 billion buyout. The acquisition of Orkin Exterminating Company in 1964 is also one of the most significant leveraged buyouts transactions. In this case Transaction is first documented leveraged buyout in U.S. business history.

Since 2000, the number and value of LBOs of U.S. target companies completed by private equity funds have increased significantly. There are three major factors to push up this growth: (1) the increased interest in private equity investments by pension plans and other institutional investors; (2) the attractiveness of some publicly traded companies, owing to relatively low debt and inexpensively priced shares; and (3) the growth in the global debt market, permitting borrowing at relatively low rates.

## POSITION OF LEVERAGED BUYOUT IN INDIA

Under Section 77(2) of the Companies Act, 1956<sup>xv</sup>, the target company cannot provide security, financial assistance, to the lenders so as to provide finance to the managers to acquire shares in the target company. Any contravention of this provision could not only lead to the security being considered void, but would also expose the target company to punishment in the form of fine. However, there is an exception in the case of private limited companies that are not subsidiaries of public limited companies as such companies are not within the purview of the prohibition on financial assistance.

In the Indian position on 'financial assistance' is fairly stringent compared to that in other common law countries. In other common law jurisdictions, there is either no prohibition on 'financial assistance' such as most U.S. states, including Delaware or there are processes to overcome the prohibition through what is referred to as the 'whitewash procedure'<sup>xvi</sup>, that is practiced, for instance, in the U.K. and Australia. The stringency of the 'financial assistance' law is the main reason why leveraged buyout is not that popular in the Indian markets. Therefore, the time comes when India needs to proceed with the amendment in respect of this issue to make the acquisition a bit lenient so that this will become another option for investors.

In India, the acquiring company can form a Special Purpose vehicle (SPV) which was a 100% subsidiary of the acquirer with a minimum equity capital. The SPV leveraged this equity to make the debt to buyout the

target company. This debt, later on, will be paid off by the SPV through the target company's own cash flows. The target company's assets were pledged with the lending institution and once the debt was redeemed, the acquiring company had the option to merge with the SPV. Thus the liability of the acquiring company was limited to its equity holding in the SPV. Thus, in an LBO, the takeover was financed by the target company's future internal accruals. This reduced the burden on the acquiring company's balance sheet and made the entire takeover a low risk affair.

In the summer of 2000, there was the landmark deal in the history of the Indian corporate which some may have never seen or heard before at that time. Because apart from the size of the deal, what made it particularly special was the fact that it was the first ever leveraged buy-out by any Indian companies, "Tata Tea". Tata Tea acquired the UK famous brand Tetley<sup>xvii</sup> for a staggering 271 million pounds. This deal which happened to be the largest cross-border acquisition by any Indian company marked the culmination of Tata Tea's strategy of pushing for aggressive growth and worldwide expansion. This method of financing had never been successfully attempted before by any Indian company. Tetley's price tag of US \$450 million was more than four times the net worth of Tata tea which stood at US \$114 million. This LBO allowed the Tata Tea to make the purchase with the small amount of money.

The purchase of Tetley was funded by a combination of equity, subscribed by Tata tea, junior loan stock subscribed by institutional investors including the vendor institutions Mezzanine Finance, arranged by Intermediate Capital Group Plc. and senior debt facilities arranged and underwritten by Rabobank International. Tata Tea created a Special Purpose Vehicle (SPV)-christened Tata Tea (Great Britain) to acquire all the properties of Tetley. The SPV was capitalized at 70 million pounds, of which Tata tea contributed 60 million pounds; this included 45 million pounds raised through a GDR issue. The US subsidiary of the company, Tata Tea Inc. had contributed the balance 10 million pounds. The SPV leveraged the 70 million pounds equity 3.36 times to raise a debt of 235 million pounds, to finance the deal<sup>xviii</sup>.

## STRUCTURING CONSIDERATIONS FOR LBO IN INDIA

Chokshi (2007) has expressed that the obstacles to operate the LBO in India, has brought two buyout structures, namely the Foreign Holding Company Structure and the Asset Buyout Structure.

### The Foreign Holding Company

Debt for the acquisition is entirely raised by such foreign

holding company from foreign banks and these proceeds are used to purchase equity of the Indian target (Taneja, 2008)<sup>xix</sup>. The amount being invested to purchase a stake in the India Operating Company is channeled into India as FDI. The seller of the Indian Operating Company may participate in the LBO and receive securities in the Foreign Holding Company as part of the payment, such as rollover equity and seller notes. The operating assets of the purchased business are within the corporate entity of the Indian Operating Company. As a result, cash flows are generated by the Indian Operating Company while principal and interest payment obligations reside in the Foreign Holding Company. The Indian Operating Company makes dividend or share buyback payments to the Foreign Holding Company, which is used by the latter for servicing the debt. Under the current FDI regime foreign investments, including dividends declared on foreign investments, are freely repatriable through an Authorized Dealer.

### **The asset buyout structure**

The financial investor incorporates a Domestic Holding Company and finances it using debt and equity. The debt is incurred based on a purchase agreement to purchase operating assets and is secured by those assets, since asset-backed, project loans and secured working capital loans is permissible for domestic banks in India. The Domestic Holding Company then purchases the operating assets of the business on an asset-by-asset basis for example, land, building, machinery etc. Foreign investors may invest in the equity of the Domestic Holding Company through the FDI route.

While both instances, result in stamp duties, in the latter, additional VAT challenges arise, which can be addressed depending on the facts of the case. This structure is feasible only if the acquirer is looking at acquiring a 100% stake in the target company. It is not possible to use this structure, for instance, if the intention is merely to acquire a majority or controlling stake. Further, it should also be noted here that the cash for the sale flows not to the shareholders, but to the target company.

## **ADVANTAGES AND DISADVANTAGES OF LBO**

### **Advantages of leveraged buyout**

A successful LBO can provide a small business with a number of advantages. For one thing, it can increase management commitment and effort because they have greater equity stake in the company. In a publicly traded company, managers typically own only a small percentage of the common shares, and therefore can participate in only a small fraction of the gains resulting

from improved managerial performance. After an LBO, however, executives can realize substantial financial gains from enhanced performance. This improvement in financial incentives for the firm's managers should result in greater effort on the part of management. Similarly, when employees are involved in an LBO, their increased stake in the company's success tends to improve their productivity and loyalty (Wadadekar, 2009).

Another potential advantage is that LBOs can often act to revitalize a mature company. In addition, by increasing the company's capitalization, an LBO may enable it to improve its market position. Successful LBOs also tend to create value for a variety of parties. For example, the firms' shareholders can earn large positive abnormal returns from leveraged buyouts. Similarly, the post-buyout investors in these transactions often earn large excess returns over the period from the buyout completion date to the date of an initial public offering or resale.

Moreover there is tax advantage associated with acquiring a company through debt financing rather than an outright purchase because the cost of servicing the debt is deductible. This actually allows the acquirers to pay more for the acquired company than would otherwise be possible, an obvious benefit to the sellers.

### **Disadvantages of leveraged buyout**

Although there are many advantages in LBO that is, the investor can buy the or acquire the firm with the small of equity and large amount of loan from the bank and get the control over the acquired firm, there are also some dangers for the investor who acquire or get the company through this route of investment, Leveraged Buyouts. Investment through this route can make the failure more than other entries of investment also. In leveraged buyouts the investor, even though, has only 10% of equity share and has to take 90% of debt for the easily investment, this will cause the risks or troubles to the investment circulation. Not only the firm which cannot ask for more money without the collateral will be colluded but also the bank which will not get the money back from the firm which is the debtor or loanee.

Some LBOs in the 1980s and 1990s resulted in corporate bankruptcy, such as Robert Campeau's 1988 buyout of Federated Department Stores<sup>xx</sup>. In *Robert Campeau case*, the failure of the Leveraged Buyouts transaction is quite obvious especially in 1980 which the investment through LBO was popular. Robert Campeau would like to expand the shopping mall so it had acquired two companies, Allied Stores and Federated Department Stores. Robert took the loan from the bank but it could not be able to return the debt obligation to the bank. Eventually they had been bankrupted.

Platt and Platt (1991)<sup>xxi</sup> had collected data on virtually every LBO that filed public documents during the eight-year

period ending in 1989. The final data set was composed of 48 successful LBOs and 20 failed LBOs. Failed LBOs included companies which filed for bankruptcy protection and one additional company that later did an IPO at a price below the original LBO equity infusion value. The factors Harlan D. Platt and Marjorie Platt reviewed as possible causes of LBO success or failure include profitability, indebtedness, liquidity and management efficiency. To measure these they created 26 ratios from financial and accounting data gathered from the 68 companies. Most of the ratios proved to be unrelated to LBO success and did not contribute to the final model.

On July 28, 1988, another most notable failure in the LBO transaction, *Revco Drug Stores* case filed for bankruptcy (Wruck, 1986)<sup>xxii</sup>. This is another example of the LBO's failure, the firm collapsed merely 19 months after going private. At closing in December 1986, the leveraged buyout (LBO) was one of the largest ever, \$1.4 billion, and, featuring nine discrete layers of securities in the capital structure. On December 17, 1990, the court-appointed U.S. Bankruptcy Examiner opined that the Revco case revealed "viable causes of action against a broad panoply of defendants under fraudulent conveyance".

## CONCLUSION

Leveraged buyout is one of the interesting routes for those investors who do not have the high equity in the pocket and can acquire another target company. The investors can come up with the control over the management of the target company. In case the investors have the experience to manage the target company's business especially in the case of management buyout which the business of the target company will be run by the insiders then the investors can use the cash flow coming to such company to repay the loan taking from the bank.

However, there are some certain risks if the investors cannot revive the business of the target company and finally the expectation of such cash flow for the loan repayment will not happen. The high interest rates from such loan may make the extra burden to investors to return the interest and the loan to the bank. Consequently there is the chain of the business collapse not only the

target company but also the bank which gives the loan to the investor to acquire such company. In the case of management buyout it can also cause the conflict of interest among employees, executives and the management team. Thus the stability and experience of the investors are significance factors for running the leveraged buyout investment.

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## ENDNOTES

<sup>i</sup> It was characterized by Victor Posner's hostile takeover of Sharon Steel Corporation in 1969. Victor Posner was a US businessman, millionaire and philanthropist. He was known as one of the highest paid business executives of his generation. He was a pioneer of the leveraged buyout.

<sup>ii</sup> Leveraged Buyout – also called as 'Highly-Leveraged Transaction (HLT)' – occurs when a financial sponsor gains control of a majority of a target company's equity through the use of borrowed money or debt. The nature of the debt used in LBOs is typically subordinated debentures. In fact, most LBOs are financed with a high proportion of so-called "junk" (that is, high-yield) bonds.

<sup>iii</sup> Free cash flow is a measure of financial performance and is defined as cash flow available for distribution among any parties that hold security in a company. It comprises the net income plus depreciation and amortization minus capital expenditure and any changes in working capital. The free cash flow is the cash that a company has available for use after paying out the necessary expenditure to maintain or expand its asset base. It matters, as it is a means for a company to boost shareholder value through, for example, mergers and acquisitions, R&D, paying dividends, or reducing debt. It can thus be viewed as an alternative bottom line.

<sup>iv</sup> LBO Candidate Criteria

- Steady and predictable cash flow
- Divestible assets
- Clean balance sheet with little debt
- Strong management team
- Strong, defensible market position
- Viable exit strategy
- Limited working capital requirements
- Synergy opportunities
- Minimal future capital requirements
- Potential for expense reduction
- Heavy asset base for loan collateral

<sup>v</sup> E.g., in *Durfee v. Durfee & Canning, Inc.*, 323 Mass. [187.] 200-202, 80 N.E.2d 522 [(1948)], the credit weakness of the corporation did not permit Canning, who was a director and principal officer, to turn to his own account the purchase of gasoline which would have been advantageous to the corporation.

<sup>vi</sup> "A public policy, existing through the years, and derived from the profound knowledge of human characteristics and movies...demands of the corporate officer or director...the most scrupulous observance of his duty not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.

<sup>vii</sup> For example, employee at Weirton Steel saved it from imminent closing, then took a 19% pay cut, and raised \$300 million to buy the assets in 1983. Since Weirton has embarked on a significant modernization program.

<sup>viii</sup> According to European Venture Capital Association (EVCA) figures, private equity investments in 2005 represented 0.4% of the EU average GDP, up from 0.25% in 2001. Within the EU, Denmark received the largest share of investments relative to the size of the economy (1.2%) in 2005, followed by Sweden (0.9%), the UK (0.7%) and the Netherlands (0.6%).

<sup>ix</sup> In fact, the pre-LBO management of the target company and the general partners may be the same persons, in which case the undertaking would be called a "management buyout".

<sup>x</sup> Senior debt – A class of debt that has priority with respect to interest and principal over other classes of debt and over all classes of equity by the same issuer. In the event of financial difficulties or liquidation of the borrower's assets, holders of senior debt will have a priority claim. Most loans from financial institutions and certain high-grade debt securities such as mortgage bonds are senior debt. Because senior debt has a relatively secure claim, it is less risky from the point of view of the lender and it pays a lower rate of interest compared with debt of the same issuer having a subordinate claim. It is generally issued in various loan types (or tranches) with different risk-return profiles, repayment conditions and maturity. These are (ranked by seniority):

- Term loan A (or tranche A): safest type of senior debt, generally with a fixed amortisation schedule and maturity between six and seven years;
- Term loan B (or tranche B): lower-grade senior debt tranche, typically featuring a bullet structure;
- Term loan C (or tranche C): lowest- grade senior debt, also featuring a bullet structure.

<sup>xi</sup> Second lien debt: debt that ranks *pari passu* in right of payments with first lien debt, being secured on the same collateral. However, inter-creditor arrangements can, for example, prohibit or restrict the ability of second lien creditors to exercise remedies against the collateral and challenge any exercise of remedies by the first lien lenders.

<sup>xii</sup> Mezzanine debt: *Mezzanine finance* is unsecured debt (or preference shares) offering a high return with a high risk. This type of debt generally offers interest rates two to five percentage points more than that on senior debt and frequently gives the lenders some right to a share in equity values should the firm perform well. *Mezzanine finance* tends to be used when bank borrowing limits are reached and the firm cannot or will not issue more equity. The finance it provides is cheaper (in terms of required return) than would be available on the equity market and it allows the owners of a business to raise large sums of money without sacrificing control. It is a form of finance which permits the firm to move beyond what is normally considered acceptable debt/equity ratios (gearing or leverage levels).

<sup>xiii</sup> High-yield bonds: bonds with non-investment grade credit ratings that offer investors higher yields than bonds of financially sound companies; also known as "junk bonds".

<sup>xiv</sup> Payment-in-kind loans or notes: securities which give the issuer the option to make interest/capital payments in the form of additional securities or to postpone such payments if certain performance triggers have not been met.

<sup>xv</sup> Section 77(2) of the Companies Act, 1956: "No public company, and no private company which is a subsidiary of a public company, shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company or its holding company ..."

<sup>xvi</sup> It is necessary for the accountants for the company to provide a report confirming that they believe that the assistance, in their opinion, can be given. The shareholders of the target business must also agree to the assistance being given by approving a special resolution (75% of the share holders must approve the transaction). It is also necessary for the directors of the target business, which is giving the assistance to execute a statutory

declaration saying that they believe that they have complied with the financial assistance provisions and that the business will be solvent for the period of 12 months from the date of the statutory declaration.

<sup>xvii</sup> A fully owned subsidiary of Tata Tea limited is the world second largest manufacturer and distributor of tea, the first being Unilever, owner of Brooke Bond and Lipton. Owned by India's Tata group, Tetley's manufacturing and distribution business is spread across 40 countries and sells over 60 branded tea bags. It is the largest tea company in the United Kingdom and Canada and the second largest in the U.S.A.

<sup>xviii</sup> The entire debt amount of 235 million pounds comprised 4 tranches whose tenure varied from 7 years to 9.5 years, with a coupon rate of around 11%. The Netherlands based Rabo Bank had provided 215 million pounds, while venture capital funds, Mezzanine and Shareholders contributed 10 million pounds each. While A, B, and C were senior term loans, trench D was a revolving loan that took the form of recurring advances and letters of credit. Of the four tranches A and B were meant for funding the acquisition, while C and D were meant for capital expenditure and working capital requirements respectively. The debt was raised against Tetley's brands and physical assets. The valuation of the deal was done on the basis of future cash flows that the brand was expected to generate along with the synergies arising out of the acquisition.

<sup>xix</sup> One of the main issues here, from the acquirers point of view, is that the assets lie in India at the target company level, and these assets cannot be used as collateral for financing the debt taken by the acquisition company situated abroad. The other major issue could be the foreign currency risk as the debt is in foreign currency whereas the returns in the hands of the acquirer company from the Indian target, which are used to service the foreign debt, would be rupee denominated.

<sup>xx</sup> In the 1980s Campeau embarked on a series of leveraged buyouts (LBOs), first bidding unsuccessfully on the *Royal Trust* company (now part of the Royal Bank). As his business expanded, Campeau ventured into the United States, looking for acquisitions that would add shopping mall real estate to his portfolio of assets. Through junk bond LBOs which were at their most popular in the mid 1980s, his Campeau Corporation gained control of Allied Stores and Federated Department Stores, owner of Bloomingdale's. Campeau retained famous banker Bruce Wasserstein to assist with the transactions. However, the debt obligations that needed to be covered following the merger were too large and exacerbated by a market downturn that hurt retail sales; Campeau Corporation was unable to meet its debt obligations. Federated and Allied eventually filed for bankruptcy reorganization. The company was eventually acquired by the Reichman brothers who went bankrupt themselves and Campeau Corporation ceased to exist. "Any corporate executive can figure out how to file for bankruptcy when the bottom drops out of the business. It took the special genius of Robert Campeau, chairman of the Campeau Corporation, to figure out how to bankrupt more than 250 profitable department stores. The dramatic jolt to Bloomingdale's, Abraham and Straus, Jordan Marsh and the other proud stores reflects his overreaching grasp and oversized ego"

<sup>xxi</sup> Knowing that LBOs are a recipe for success is only half the story. The other half concerns the extraordinary risk created by the investment's colossal debt. This illustration provides LBO investors with management tips gleaned from an empirical model of failure assessment that may help them to avoid trouble. LBOs are more likely to fail than other firms are. We estimate the annual LBO failure rate at slightly more than 4%, which greatly exceeds the approximate 1% failure rate of normally levered firms. Fundamentally, LBOs fail for the same reasons that trouble other firms (inadequate gross margins, excessive debt levels and macroeconomic perturbations), but the "boiling point" for LBOs is much lower. Low gross margin levels weaken any firm, but with a debt ratio exceeding 70% and equity levels at 10% or less, LBOs have little margin for error. Disproportionately high debt levels contribute to bankruptcy in several ways: firms are unable to borrow additional funds, debt-servicing requirements are high, debt covenants may be strict and profitable new investments are missed because additional money is unavailable.

<sup>xxii</sup> It was one of the nation's largest retail drug chains, operating over 2,000 stores in 30 states. Approximately \$1.55 billion was raised to finance the purchase of the company. The deal raised management's equity stake from 3% to 31%, and increased the company's debt from \$309 million to \$1.3 billion. In July 1988, less than two years after the buyout, Revco filed for protection from its creditors under Chapter 11 of the U.S. Bankruptcy Code. Given the company's heavy debt burden, many observers viewed this outcome as inevitable. For example, Theodore J. Forstmann, senior partner of the buyout firm Forstmann Little & Co., commented: "Revco is a case study of what happens when companies take on too much debt. Where junk bonds are concerned, there will be many more Revcos."