

Leveraged Buyout Overview

A leveraged buyout (LBO) is a fundamental, yet complex acquisition commonly used in the investment banking and private equity industries. We will take a look at the basic concepts, benefits, and drawbacks of a leveraged buyout. We will understand how to effectively analyze an LBO. We will further analyze the fundamental impact of such a transaction and calculate the expected return to an investor. Last, we will spend time interpreting the variables and financing structures to understand how to maximize investor rate of return (IRR).

The three goals of this part are:

1. Understanding leveraged buyouts (leveraged buyout theory).
 - Concepts.
 - Purposes and uses.
2. Valuation overview (What is value?)
 - Book value, market value, equity value, and enterprise value.
 - Understanding multiples.
 - Three core methods of valuation:
 - i. Comparable company analysis.
 - ii. Precedent transactions analysis.
 - iii. Discounted cash flow analysis.
3. Ability to understand a simple IRR analysis (leveraged buyout analysis).
 - a. Purchase price.
 - b. Sources and uses.
 - c. Calculating investor rate of return (IRR).

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Leveraged Buyout Theory

A leveraged buyout is an acquisition of a company using a significant amount of debt to meet the cost of the acquisition. This allows for the acquisition of a business with less equity (out-of-pocket) capital. Think of a mortgage on a house. If you take out a mortgage to fund the purchase of a house, you can buy a larger house with less out-of-pocket cash (your down payment). Over time, your income will be used to make the required principal (and interest) mortgage payments; as you pay down those principal payments, and as the debt balance reduces, your equity in the house increases. Effectively, the debt is being converted to equity. And maybe you can sell the house for a profit and receive a return. This concept, on the surface, is similar to a leverage buyout. Although we use a significant amount of borrowed money to buy a business in an LBO, the cash flows produced by the business will hopefully, over time, pay down the debt. Debt will convert to equity, and we can hope to sell the business for a profit.

There are three core components that contribute to the success of a leveraged buyout:

1. Cash availability, interest, and debt pay-down.
2. Operation improvements.
3. Multiple expansion.

CASH AVAILABILITY, INTEREST, AND DEBT PAY-DOWN

This is the concept illustrated in the chapter's first paragraph. The cash being produced by the business will be used to pay down debt and interest. It is the reduction of debt that will be converted into the equity value of the business.

It is for this reason that a company with high and consistent cash flows makes for a good leveraged buyout investment.

OPERATION IMPROVEMENTS

Once we own the business, we plan on making some sort of improvements to increase the operating performance of that business. Increasing the operating performance of the business will ultimately increase cash flows, which will pay down debt faster. But, more important, operating improvements will increase the overall value of the business, which means we can then (we hope) sell it at a higher price. Taking the previous mortgage example, we had hoped to make a profit by selling the house after several years. If we make some renovations and improvements to the house, we can hope to sell it for a higher price. For this reason, investors and funds would look for businesses they can improve as good leveraged buyout investments. Often the particular investor or fund team has particular expertise in the industry. Maybe they have connections to larger sources of revenue or larger access to distribution channels based on their experience where they feel they can grow the business faster. Or, maybe the investor or fund team sees major problems with management they know they can fix. Any of these operation improvements could increase the overall value of the business.

MULTIPLE EXPANSION

Multiple expansion is the expectation that the market value of the business will increase. This would result in an increase in the expected multiple one can sell the business for. We will later see, in a business entity, we will most likely base a purchase and sale off of multiples. We will also conservatively assume the exit multiple used to sell the business will be equal to the purchase multiple (the multiple calculated based on the purchase price of the business). This would certainly enhance the business returns.

WHAT MAKES GOOD LEVERAGED BUYOUT?

In summary, a good leveraged buyout has strong and consistent cash flows that can be expected to pay down a portion of the debt raised and related interest. Further, the investor or fund sees ways to improve the operating performance of the business. It is hoped that the combination of debt converting into equity and the increase in operating performance would significantly increase the value of the business. This results in an increase in returns to the investor or fund. The next pages of this book step through such an analysis in its entirety and are intended to give you the core understanding of how such an analysis can provide not only benefits to a company, but

high returns to an investor. This will also indicate pitfalls many investors face and reasons why many LBOs may not work out as planned.

EXIT OPPORTUNITIES

The financial returns from a leveraged buyout are not truly realized until the business is exited, or sold. There are several common ways to exit a business leveraged buyout:

1. Strategic sale: The business can be sold to a strategic buyer, a corporation that may find strategic benefits to owning the business.
2. Financial sponsor: Although not too common, the business can be sold to another Private Equity firm, maybe one with a different focus that can help take the business to the next level.
3. Initial public offering (IPO): If the company is at the right stage, and if the markets are right, the company can be sold to the public markets—an IPO
4. Dividend recapitalization: Although not necessarily a sale, a dividend recapitalization is a way for a fund to receive liquidity from their business investments. Think of it like refinancing a mortgage or taking out a second mortgage on your home in order to receive cash. The business will raise debt and distribute the cash raised from the debt to business owners or fund management.

IS HEINZ A LEVERAGED BUYOUT?

There is a debate on whether the Heinz situation is technically a leveraged buyout. I believe we can all agree this is in fact a buyout; Heinz is being acquired by 3G Capital and Berkshire Hathaway. But is the buyout leveraged? Those believing that the Heinz deal is not a leveraged buyout argue that the debt raised to meet the acquisition cost is not significant enough to constitute a leveraged buyout. I agree that what justifies the amount of debt raised to be *significant* is not formally defined in the leveraged buyout world. However, we will see in Chapter 4 that the amount of debt raised is approximately 40 percent to 45 percent of total funds used to acquire Heinz; I believe this is a significant amount of debt. The second important thing to consider is *how* the debt is being raised. In a leveraged buyout, typically the debt raised is backed by the assets of the company being purchased. As this will most likely be the case for Heinz, I would certainly consider this a leveraged buyout.

Others also argue this is not technically a leveraged buyout based on intent. In other words, the Heinz buyers are stating that their intent is not to exit the investment after a fixed time horizon, as is often the case for large buyout funds. Although this may be true, I am not sure “intent” is an appropriate determinant of what constitutes a leveraged buyout. It is still a buyout; it is still leveraged. Whether you believe the transaction is a leveraged buyout still stands as a relatively subjective debate. For purposes of instruction, we will model the case as if it were a full-fledged leveraged buyout. What’s interesting is that the modeling does not change either way.

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