St. Xavier's College (Autonomous), Kolkata

XAVIER'S FINANCE COMMUNITY

Presents

RELEVANCE OF LEVERAGED BUYOUTS IN TODAY'S WORLD

CONTENTS

I. Introduction

II. Working of a Leveraged Buyout(LBO)

III. Popular LBOs:

A. Blackstone Group and Hilton

B. Kinder Morgan

C. Patanjali and Ruchi Soya

IV. LBO Landscape in India

V. Comparision with other P.E. Strategies

VI. Conclusion

VII. References

Introduction

A leveraged buyout (LBO) refers to the leveraged acquisition of a company, with the debt being collateralized against the target company's assets. The use of high leverage enhances the return on equity and internal rate of return on the investment. Buyouts currently form a significant portion of private equity activity. In the second quarter of CY 2021 alone, the total value of private equity buyout deals amounted to $418 billion. In this article, we will investigate the relevance of LBOs in today's world by exploring how they work, reviewing famous LBO deals, studying the LBO landscape in India and comparing LBOs with other stratgies employed by private equity firms.

Working of a Leveraged Buyout(LBO)

While each LBO has its own nuances, it generally involves the following steps:

1. **Identifying suitable companies**: Stable, established companies with robust, predictable cash flows tend to make suitable candidates for buyouts. Additionally, low debt, scope for expense reduction, sizable value of tangible assets for loan collateral, and minimal reinvestment needs are all desirable characteristics for a target company.

2. **Choosing and securing the right form of financing**: The financing depends to a large extent upon the company's financials and credibility and may come from disparate sources, such as bank credit, mezzanine financing and bond issues. If bonds are issued, they are generally rated as junk bonds due to the high amount of leverage involved.

3. **Approaching the target company**: The acquirer approaches the management with its offer to buy the target company. The acquirer and the management must reach a consensus with regards to the final terms of the acquisition. Once the terms are finalised, the deal is consummated.

4. **Exit:** After holding the target company for a period of time, the acquirer seeks an exit. The most rational exit involves the sale of stake to another company or PE firm. However, sometimes this might not be possible due to constrained liquidity or lack of potential buyers in the marketplace. In such a case, the acquirer may opt for an IPO or recapitalization. An IPO, albeit a viable option, does not ensure a complete exit as liquidation of the entire stake sends a negative signal and discourages potential investors. In case the acquirer decides to hold the company indefinitely, it may opt for recapitalization, wherein the company keeps issuing hefty dividends to the acquirer from its Free Cash Flow

We provide below a simple illustration of a leveraged buyout: Private equity firm Buyco Capital wishes to acquire Sellco LLC through an LBO. Sellco's balance sheet, shown below, reports total assets worth Rs 9 Cr which are financed purely by equity.

BALANCE SHEET OF SELLCO			
Liabilities	Amount	Assets	Amount
Non-Current Liabilities:		**Non-Current Assets**	800
Equity	900	**Current Assets**	100
Debt	0		
Current Liabilities	0		
	900		900

Sellco is involved in a low-risk business with stable yearly pre-tax earnings of Rs 1.5 Cr. Sellco has agreed to a deal value of Rs 10 Cr for its business, and Buyco decides to finance it with Rs 1 Cr cash and a 10% Rs 9 Cr loan from a bank. Assuming a tax rate of 30%, the net earnings with and without the use of debt are:

BALANCE SHEET OF SELLCO			
Liabilities	Amount	Assets	Amount
Non-Current Liabilities:		**Non-Current Assets**	800
Equity	900	**Current Assets**	100
Debt	0		
Current Liabilities	0		
	900		900

After paying interest every year, the post-tax earnings are Rs 42 lacs. Thus, the annualized yield earned by Buyco if Sellco is sold at the purchase price is 42% on Rs 1 Cr. by using an LBO, much higher than 10.5% on Rs 10 Cr, the yield from a pure cash buyout.

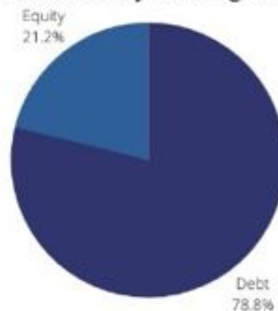
The above illustration is very simplistic; in reality, the target company may have reinvestment needs that may require additional financing, the leverage ratio may be capped by regulatory restrictions, the interest rate on debt may be higher especially when the buyout is financed through the issue of bonds which get rated as junk issues due to the use of high leverage, and the firm may not be able to keep its earnings stable. Additionally, PE firms often resort to harsh cost-cutting practices to improve return, by laying off employees and stripping the target company's assets.
We now provide an outline of some of the famous LBOs.

Popular LBOs

The first leveraged buyout may have been the purchase by McLean Industries of Pan-Atlantic Steamship Company and Waterman Steamship Corporation in 1955. The leveraged buyout boom of the 1980s was conceived in the 1960s notably by Henry Kravis and Jerome Kohlberg who later went on to establish the prestigious private equity firm KKR. Today, many private equity firms employ LBOs in their strategy. We have outlined below some of the most famous LBO deals that have taken place in recent years.

Blackstone Group and Hilton

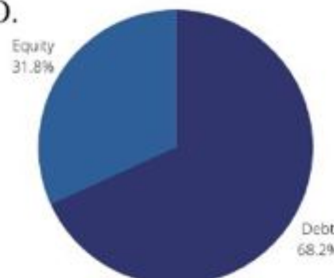
To take its business international, Hilton Hotels had taken on a huge amount of debt, and sustenance was becoming difficult. It needed a partner with experience in the hospitality industry to help expand overseas. In 2007 Blackstone Group took Hilton Hotels Corporation private in an all-cash LBO deal worth $26 billion, of which $20.5 billion was financed through debt. In 2018, nearly after 11 years, Blackstone Group made a complete exit by selling its entire stake, making a stellar return on its initial investment.



Hilton LBO (in billions of US$)

Kinder Morgan

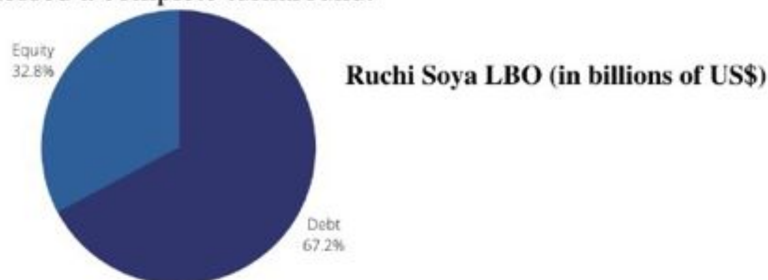
Valued at $22.4 billion, the 2006 Kinder Morgan LBO was one of the largest buyouts of its time. It was an attempt to garner greater ownership by the chief executive Rich Kinder. A consortium of Goldman Sachs and the owner-manager Rich Kinder proposed to put in $15 billion of capital, raising debt to the tune of $7 billion to finance the acquisition. The company was taken public in 2011 in a private equity-backed IPO.



Kinder Morgan LBO (in billions of US$)

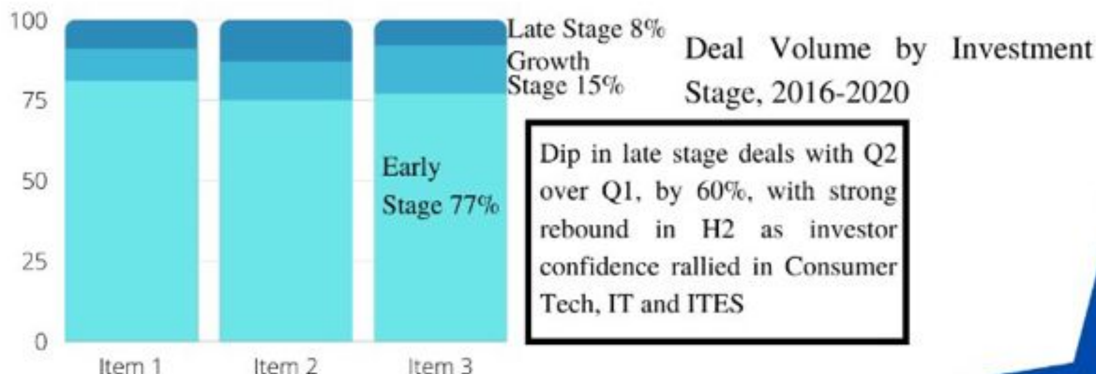
Patanjali and Ruchi Soya

The Rs 4,350 Cr buyout of bankrupt Ruchi Soya by Patanjali Ayurveda in 2019 is deemed to be one of the largest buyouts in India. For the acquisition, Patanjali Ayurveda put in Rs 1100 Cr and financed the remainder through bank credit. Post the buyout, all the lenders of the bankrupt company have been paid in full and the company has witnessed a complete turnaround.



LBO landscape in India

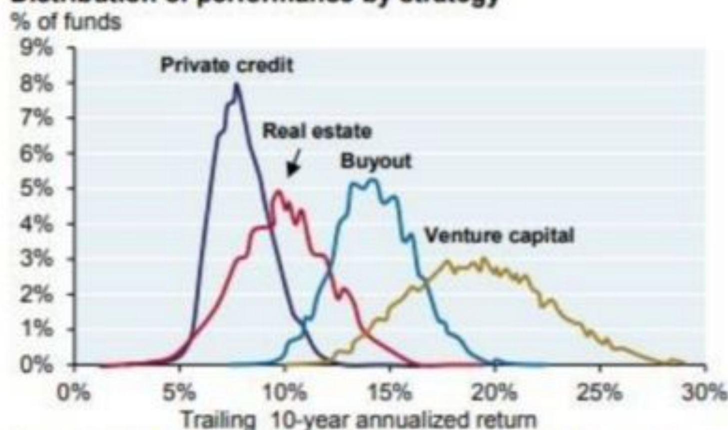
Indian Corporates seem to have utilised the LBO model of investing quite well, by securing loans from foreign institutions to invest in foreign companies, as is evident from a large number of such deals that have taken place of late. These include Tata Tea's acquisition of Tetley, Tata Steel's acquisition of Corus, UB Group's acquisition of Whyte and Mackay, Tata Motors's acquisition of American Axle and Suzlon Energy's acquisition of Hansen Transmissions. However, when it comes to the acquisition of Indian companies, the scene is quite different. The figure below classifies Indian private equity deal volume from 2016-20 by financing stage of the investments.



It is clear that while buyouts are one of the most favored PE strategies in developed markets, they only form a small portion (~8%) of Indian private equity activity. The COVID pandemic led to a shift in private equity strategy, with firms focusing on opportunistic sales and qualified institutional placements, but buyout deals continue to rise in India. Regulatory restrictions in India seem to have constrained the growth of LBO's, which are currently confined to stressed companies. In order to ensure that the stressed companies achieve the desired benefits by adopting the LBO framework, the Indian regulatory authorities need to include deterrent laws by which non-serious stakeholders can be kept at bay. Modifying the LBO framework would make it more investor friendly and would provide an impetus for investment of funds by way of LBO, thereby making it more cost effective and attractive. LBO's have garnered approval and success; however, their effectiveness and approval in India remains to be seen.

Comparision with other P.E. Strategies

Leveraged buyouts form just a part of the broad range of strategies employed by private equity firms, which also include private credit, real estate, growth equity and venture capital.



The figure above shows the distribution of returns from different strategies for US private equity firms from 2010-2019. It can be observed that the annualized 10-year yields of the bottom 50% buyout firms range from 7-15% while those of the top 50% funds lie in the range of 15-23%. On average, buyout funds have higher returns than private credit firms, slightly better returns than real estate, and lower returns than venture capital. However, the variance in returns for venture capital is also higher while that for real estate is similar. Overall, leveraged buyouts stand out as a powerful strategy for private equity firms. The table below offers a comparison of risks involved in LBO, growth equity and venture capital.

Type of Risk	Leveraged Buyout	Growth Equity	Venture Capital
Default Risk	Present: Use of debt is central to LBOs	Limited: Growth businesses do not employ significant amount of debt	Limited: Venture capital firms usually offer capital in exchange for equity
Market Risk	Absent: Usually mature businesses are acquired	Absent: Growth businesses operate in emerging or mature markets	Present: Startups often operate in new markets
Product Risk	Absent: Usually mature businesses are acquired	Absent: Growth businesses have developed commercial grade products	Present: Startups often have prototypes but not commercial grade products
Execution Risk	Present: The investment may fail if acquired firm is not able to maintain stable earnings	Present: Growth business may not be able to efficiently use capital	Present: Startups may not be able to successfully develop or market the product and eat up the capital
Risk of Capital Loss	Low	Moderate	High

Conclusion

Leveraged Buyouts have had a notorious history, especially in the 1980s when several prominent buyouts led to eventual bankruptcies of the acquired companies. Moreover, they have also garnered a reputation for being a ruthless and predatory tactic. While there are LBOs that lead to massive layoffs and asset selloffs, some can also be part of long-term plans to save a company. Regardless of what they are called or how they are portrayed, they will always be a part of an economy as long as there are companies, potential buyers, and money to lend. In fact, leveraged buyouts remain one of the most popular strategies employed by private equity firms today. Although their scope is currently restricted in India, the recent acquisition of Ruchi Soya by Patanjali bears testament to the increasing acceptance of such investment models in one of the fastest-growing economies and could herald a chain of such acquisitions in India in the future.

This article has been written by:
Harsh Sharma(B.Sc Eco (Hons.)) second-year student at St. Xavier's College, Kolkata, and a part of the Core Finance Team in the Xavier's Finance Community.
and;
Aryan Dugar(B.Com (Hons.) Morning) second-year student at St. Xavier's College, Kolkata, and a part of the Core Finance Team in the Xavier's Finance Community.

Designed by:
Harsh Harlalka(B.Com (Hons.) Morning) second-year student at St. Xavier's College, Kolkata, and a part of the Designing and Marketing Team in the Xavier's Finance Community.