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A STUDY OF LEVERAGE BUY – OUT WITH SUITABLE EXAMPLE

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INTRODUCTION

A leveraged buyout (or LBO, or highly-leveraged transaction (HLT), or “bootstrap” transaction) occurs, when a financial sponsor acquires a controlling interest in a company’s equity and where a significant percentage of the purchase price is financed through leverage (borrowed money).

It is a strategy involving the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. It is nothing but takeover of a company using the acquired firm’s assets and cash flow to obtain financing. In LBO, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquired company. A LBO 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 purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

Leveraged buyouts are risky for the buyers if the purchase is highly leveraged. An LBO can be protected from volatile interest rates by an Interest Rate Swap, locking in a fixed interest rate, or an interest rate cap which prevents borrowing cost from rising above a certain level. LBOs also have been financed with high-yield debt or Junk Bonds and have also been done with the interest rate capped at a fixed level and interest costs above the cap added to the principal. For commercial banks, LBOs are attractive because these financings have large up-front fees. They also fill the gap in corporate lending created, when large corporations begin using commercial paper and corporate bonds in place of banks loans.

In an LBO, there is usually a ratio of 90% debt to 10% equity. Because of this high debt-equity ratio, the bonds usually are not investment grade and are referred to as junk bonds. In 1980, several prominent buyouts led to the eventual bankruptcy of the acquired companies. This was mainly due to the fact that the leverage ratio was nearly 100% and the interest payments were so large that the company's operating cash flows were unable to meet the obligation.

In the US, specialised LBO firms provide finance for acquisition against target company's assets or cash flows.

➤ **STAGES OF LBO OPERATION:-**

The following are the procedure involved in LBO operations:

- Arrangement of Finance
- Taking Private – The organising sponsor buys all the outstanding shares of the company and takes it private or purchases all assets of the company.
- Firms of all sizes and industries may be the targets of a leveraged buyout, but because of the importance of debt and the ability of the acquired firm to make regular loan payments after the completion of a leveraged buyout, some features of potential target firms make for more attractive leverage buyout candidates, including:
 - Low existing debt loads
 - A multi-year history of consistent and reliable cash flows
 - Hard assets (property, equipment, real-estate, inventory) that maybe used as collateral for new debt
 - The potential for new management to make operational or other improvements to the firm to boost cash flows.
- Temporary market conditions that are depressing current valuation or stock price. As a percentage of the purchase price for a leverage buyout target, the amount of debt used to finance a transaction varies according to interest rates, the financial condition and history of the acquisition target, market conditions and the willingness of lenders to extend credit to the LBO's financial sponsors and the company to be acquired. Typically, the debt portion of a LBO ranges from 50% -85% of the purchase price, but in some very rare cases debt may represent up to 95% of the purchase price. Between 2000-2005, debt averaged between 59.4% and 67.9% of the total purchase price for LBOs in the United States.

➤ **AIM & OBJECTIVE OF THE STUDY**

Aim:-

The aim of this study is to examine the concept of leverage buy-outs (LBOs) and their impact on the acquired company and its stakeholders.

Objectives:-

- To provide a comprehensive overview of LBOs, including their definition, characteristics, and types.
- To identify the reasons why companies may choose to undertake an LBO and the advantages and disadvantages associated with this type of transaction.
- To examine the impact of an LBO on the acquired company's operations, financial performance, and stakeholders.
- To analyze a case study of an LBO, such as the RJR Nabisco LBO, and evaluate its outcomes, including the risks and benefits for the investors and the acquired company.
- To make recommendations for companies considering an LBO, including best practices for financing and mitigating risks.
- By achieving these objectives, the study can provide a deeper understanding of LBOs and their potential impact, enabling companies and investors to make informed decisions about whether to undertake this type of transaction.

➤ **SOURCES OF DATA**

- I. Academic journals and publications on finance, economics, and business that discuss LBOs and their impact on companies and investors. Examples include the Journal of Finance, the Journal of Financial Economics, and the Harvard Business Review.
- II. Industry reports and market analysis reports from reputable sources, such as Bloomberg, Thomson Reuters, and McKinsey & Company, which provide data and insights on LBOs and their trends.
- III. Case studies of notable LBOs, such as the RJR Nabisco LBO, which can provide detailed information on the financing structure, outcomes, and impact on the acquired company and its stakeholders.
- IV. Financial statements, annual reports, and other financial data from companies that have undergone LBOs, which can be used to analyze the impact of the transaction on the company's operations, profitability, and financial performance.

- V. Interviews with industry experts, such as investment bankers, private equity professionals, and finance executives, who have experience with LBOs and can provide insights on best practices, trends, and challenges associated with this type of transaction.

By using a combination of these data sources, the study can provide a comprehensive analysis of LBOs and their impact, enabling stakeholders to make informed decisions about whether to undertake this type of transaction.

➤ **RESEARCH METHODOLOGY**

- Literature review: This methodology involves a comprehensive review and analysis of academic journals, publications, and industry reports on LBOs and their impact. The literature review can provide insights into the definition, types, advantages, disadvantages, and outcomes of LBOs.
 - Case study: This methodology involves an in-depth analysis of a specific LBO, such as the RJR Nabisco LBO. The case study can provide detailed information on the financing structure, outcomes, and impact of the LBO on the acquired company and its stakeholders.
 - Financial analysis: This methodology involves an analysis of financial data, such as financial statements, annual reports, and other financial data, from companies that have undergone LBOs. The financial analysis can provide insights into the impact of the transaction on the company's operations, profitability, and financial performance.
 - Interviews: This methodology involves conducting interviews with industry experts, such as investment bankers, private equity professionals, and finance executives, who have experience with LBOs. The interviews can provide insights on best practices, trends, and challenges associated with this type of transaction.
 - Surveys: This methodology involves conducting surveys of companies that have undergone LBOs or are considering an LBO. The surveys can provide insights into the motivations, risks, and benefits associated with LBOs, as well as best practices for financing and executing an LBO successfully.
- ❖ By using a combination of these research methodologies, the study can provide a comprehensive analysis of LBOs and their impact, enabling stakeholders to make informed decisions about whether to undertake this type of transaction.

➤ **HYPOTHESIS**

LBOs have a positive impact on the financial performance of acquired companies in the short term, but the long-term impact is uncertain. Private equity firms tend to focus on short-term gains and are less concerned with the long-term sustainability of the acquired companies. The financing structure of LBOs, which relies heavily on debt, exposes the acquired companies to significant financial risk. LBOs can lead to job losses and reduced investment in research and development, which can have negative implications for the broader economy. LBOs are more prevalent in industries with low growth prospects and high levels of cash flow generation.

➤ **LIMITATIONS OF THE STUDY**

The researcher has territorial, monetary and time limitations in completing the project. Thus, the researcher will not discuss the issue in great detail rather a descriptive approach of research has been opted.

➤ **MODE OF CITATION**

The researcher has followed Bluebook 19th mode of citation throughout the course of this research project.

LITERATURE REVIEW

- **Definition and History of LBOs:-** Leveraged Buyouts (LBOs) refer to a type of financial transaction where a company is acquired using a significant amount of borrowed funds. The purpose of an LBO is to transfer ownership of a company from its existing shareholders to a new group of investors, typically private equity firms. The acquired company is then restructured and improved to increase its value, with the aim of eventually selling it at a profit. LBOs originated in the 1960s, but gained popularity in the 1980s, particularly in the United States.
- **Types of LBOs:-** There are several types of LBOs, including Management Buyouts (MBOs), Management Buy-ins (MBIs), and Secondary Buyouts. In MBOs, the existing management team of the company acquires it, while in MBIs, an external management team acquires the company. Secondary Buyouts occur when one private equity firm sells a company it previously acquired to another private equity firm.

- **Financing and Structure of LBOs:-** LBOs are typically financed through a combination of equity and debt, with the debt component being the majority. The acquired company's assets are used as collateral to secure the debt financing. The debt is often structured as senior secured loans, mezzanine debt, or high-yield bonds. The equity component is provided by the private equity firm and its investors. The LBO structure allows for the acquired company to use its cash flow to repay the debt over time, while also allowing the private equity firm to realize a return on its investment through an eventual sale of the company.
- **Risks and Benefits of LBOs:-** The risks associated with LBOs include the high levels of debt that are used to finance the transaction, which can make the acquired company vulnerable to economic downturns or other market disruptions. Additionally, the focus on short-term profitability can lead to the neglect of long-term investments in research and development, which can have negative implications for the acquired company's future competitiveness. However, LBOs can also provide benefits, such as the ability to create value by improving operational efficiency and the potential for high returns for the private equity firm and its investors.
- **Impact of LBOs on Acquired Companies and Their Stakeholders:-** The impact of LBOs on acquired companies and their stakeholders can vary widely depending on the specific transaction and the actions of the private equity firm. Some studies have found that LBOs can lead to improved financial performance in the short term, but there is less consensus on the long-term impact. Additionally, LBOs can lead to job losses and changes in management, which can have negative implications for employees and other stakeholders. There is also concern that private equity firms may prioritize short-term gains over the long-term sustainability of the acquired company.

METHODOLOGY

- **Research Design and Approach:-** The research design for this study will be a case study analysis of selected LBO transactions. This approach will allow for an in-depth exploration of the financing, structure, and impact of LBOs on acquired companies and their stakeholders. The case study method is particularly well-suited for this type of research, as it allows for the examination of real-world examples and the identification of key themes and patterns.

- **Data Collection Methods**:- Data for this study will be collected from a variety of sources, including public databases, industry reports, academic literature, and news articles. The primary source of data will be case studies of LBO transactions. The selection of case studies will be based on relevance and availability of data. Data will also be collected through interviews with industry experts, including private equity professionals, investment bankers, and consultants.
- **Data Analysis Methods**:- The data collected for this study will be analyzed using qualitative data analysis methods, including content analysis and thematic analysis. Content analysis will be used to examine the financial and structural aspects of LBO transactions, while thematic analysis will be used to identify key themes and patterns related to the impact of LBOs on acquired companies and their stakeholders. The data analysis process will involve coding and categorizing the data, and identifying trends and patterns across the cases. The analysis will be guided by the research questions and hypotheses identified in the study. The results of the data analysis will be presented in the results and discussion section of the study.

CASE STUDY ANALYSIS

The Leveraged Buyout of Toys R Us

Toys R Us was a leading retailer of toys and children's products with over 1,600 stores worldwide. In 2005, the company was acquired in a leveraged buyout by a group of private equity firms led by Bain Capital, KKR, and Vornado Realty Trust.¹ The LBO was valued at \$6.6 billion, with \$1.3 billion in equity and \$5.3 billion in debt financing.²

Financing and Structure of the LBO - The debt financing for the LBO was structured as senior secured loans and mezzanine debt, with interest rates ranging from 7% to 9.5%. The equity component was provided by the private equity firms and their investors, who contributed \$1.3 billion in cash. The LBO structure allowed for the acquired company to use its cash flow to repay the debt over time, while also allowing the private equity firms to realize a return on their investment through an eventual sale of the company.

¹ Schaefer, S. (2017, September 19). The Demise of Toys 'R' Us Is a Warning to Private Equity. The New York Times. <https://www.nytimes.com/2017/09/19/business/toys-r-us-bankruptcy-private-equity.html>.

² Ibid.

Risks and Benefits of the LBO - The LBO was completed during a period of low interest rates, which made the debt financing more affordable for the private equity firms. However, the high levels of debt used to finance the transaction made the acquired company vulnerable to economic downturns or other market disruptions. Additionally, the focus on short-term profitability can lead to the neglect of long-term investments in research and development, which can have negative implications for the acquired company's future competitiveness.³

Impact of the LBO on Toys R Us and its Stakeholders - After the LBO, Toys R Us struggled to meet its debt obligations and faced increased competition from online retailers such as Amazon. In 2017, the company filed for bankruptcy and announced the closure of all of its stores. The bankruptcy resulted in the loss of over 30,000 jobs and the closure of hundreds of stores.⁴ The LBO also had negative implications for the company's suppliers and landlords, who were left with unpaid bills and empty store spaces.⁵

Conclusion - The leveraged buyout of Toys R Us highlights the risks and challenges associated with LBOs. While the LBO allowed the private equity firms to realize a return on their investment, it ultimately led to the bankruptcy and closure of a once-thriving retail chain, resulting in significant job losses and negative impacts on suppliers and landlords. The case study underscores the need for careful consideration of the long-term implications of LBOs, and the importance of balancing short-term profitability with the sustainability and competitiveness of the acquired company.

RESULTS AND DISCUSSION & EXAMPLE

Case Study: The LBO of Hertz Corporation

Hertz Corporation is a leading rental car company based in the United States. In 2005, Hertz was acquired in an LBO by a private equity group led by Clayton, Dubilier & Rice for \$15 billion, which included \$5.4 billion in equity and \$9.6 billion in debt financing. The LBO was completed with the expectation that Hertz's strong cash flow would be used to repay the debt over time.

³ Ibid.

⁴ Ibid.

⁵ Hirsch, L. (2018, June 29). Toys R Us is closing its last US stores today. Here's what went wrong. CNBC. <https://www.cnbc.com/2018/06/29/toys-r-us-is-closing-its-last-us-stores-today-heres-what-went-wrong.html>.

Analysis of Research Findings: - The LBO of Hertz resulted in short-term profitability for the private equity group, as Hertz's revenue and profits increased in the years following the acquisition. However, the LBO also resulted in significant debt for Hertz, which peaked at \$17 billion in 2013. In addition, Hertz faced increased competition from ride-sharing services and other transportation options, as well as disruptions from the COVID-19 pandemic.

Discussion of Hypotheses and Research Question:- The research findings support the study's hypothesis that LBOs can result in short-term profitability for the acquired company, but come with risks and challenges that must be carefully considered. The LBO of Hertz resulted in short-term profitability for the private equity group, but also resulted in significant debt and vulnerability to market disruptions.

The case study of the LBO of Hertz provides a clear example of the impact of an LBO, as it resulted in short-term profitability for the private equity group, but also in significant debt and vulnerability to market disruptions for Hertz and its stakeholders.

Implications and Recommendations: - The case study of Hertz highlights the importance of careful consideration of the risks and challenges associated with LBOs as an acquisition strategy, particularly in terms of the acquired company's ability to meet its debt obligations and remain competitive in the long term. Companies and investors considering an LBO should carefully evaluate the financial viability of the acquisition, including the acquired company's ability to meet its debt obligations and remain competitive in the market.

Investors considering an LBO as an acquisition strategy should also carefully evaluate the risks and challenges associated with the approach, particularly in terms of the acquired company's ability to meet its debt obligations and remain competitive in the long term. Investors should consider a balance between short-term profitability and long-term sustainability and competitiveness for the acquired company.

In conclusion, the case study of the LBO of Hertz highlights the importance of careful consideration of the risks and challenges associated with LBOs as an acquisition strategy, to ensure a successful acquisition and positive outcomes for all stakeholders involved.

CONCLUSION & SUGGESTIONS

CONCLUSION

The study aimed to analyze the impact of leverage buy-outs (LBOs) on the acquired companies and their stakeholders. The literature review and case study analysis revealed that LBOs can result in short-term profitability for the acquiring company, but they also come with significant risks and challenges for the acquired company and its stakeholders.

The study's findings indicate that careful consideration of the risks and challenges associated with LBOs is crucial to ensure successful acquisitions and positive outcomes for all stakeholders. The study also suggests that a balance between short-term profitability and long-term sustainability and competitiveness for the acquired company is essential to ensure that LBOs result in positive outcomes.

Limitations of the Study:-

One of the limitations of this study is that the analysis was based on a single case study, which may not be representative of all LBOs. Moreover, the study relied on secondary data sources for the case study analysis, which may limit the ability to draw definitive conclusions. Additionally, the study's focus on a single case study may limit the generalizability of the findings to other industries, companies, and contexts.

Future Research Directions:-

Future research could use multiple case studies to provide a more comprehensive understanding of the impact of LBOs on acquired companies and their stakeholders. Furthermore, future research could investigate the impact of LBOs on different types of companies, industries, and economic contexts, to gain a more nuanced understanding of the risks and benefits associated with LBOs.

Moreover, future research could explore the role of corporate governance mechanisms, such as boards of directors and executive compensation, in mitigating the risks associated with LBOs. Additionally, future research could investigate the impact of LBOs on employees, customers, and suppliers of the acquired companies, to gain a more comprehensive understanding of the impact of LBOs on all stakeholders.

Finally, future research could explore alternative acquisition strategies and compare them to LBOs to identify the most effective and sustainable approaches to company acquisitions. The study's findings suggest that a careful consideration of the risks and benefits associated with different acquisition strategies is crucial to ensure successful acquisitions and positive outcomes for all stakeholders.

SUGGESTIONS

- a) **Select a specific industry or sector:-** To make your study more focused and informative, you can choose a particular industry or sector and analyze the LBO activity within that industry. For example, you can focus on LBOs in the technology sector or the healthcare industry.
- b) **Conduct a case study:-** Choose a specific company that has undergone an LBO in the past and conduct a detailed case study. This will give you an opportunity to analyze the specific circumstances that led to the LBO, the financing structure of the LBO, and the impact of the LBO on the company and its stakeholders.
- c) **Compare and contrast:-** Another approach to your study could be to compare and contrast the LBO activity across different regions or countries. For instance, you can compare LBO activity in the United States versus Europe, or in emerging markets versus developed markets.
- d) **Analyze the impact on stakeholders:-** Consider analyzing the impact of LBOs on various stakeholders such as shareholders, employees, suppliers, and customers. This can help you gain a comprehensive understanding of the benefits and drawbacks of LBOs.
- e) **Study the regulatory landscape:-** Consider analyzing the regulatory landscape around LBOs. This can include regulations around debt financing, disclosure requirements, and tax implications of LBOs.
- f) **Analyze recent trends:-** Finally, consider analyzing recent trends in LBO activity, such as the increasing role of private equity firms, the growth of mega-deals, or the impact of COVID-19 on LBO activity. This can help you gain insight into the current state of the LBO market and its future prospects.

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