leveraged buy-outs

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Leveraged buy-outs (LBOs) occur when the management of a company purchases its shares from existing shareholders and effectively becomes the owner. The target is typically a public company or a subsidiary of one that is taken private, with a significant portion of the cash purchase price being financed by debt. This debt is secured not by the credit status of the purchaser but by the assets of the target company. The debt used has usually been high-yield securities of substandard investment grade quality, commonly referred to as "junk bonds."

An important criterion for an LBO is a gap between the existing market value of the firm and the value determined by a reappraisal of the assets or by the capitalization of expected cash flows. Moreover, after an LBO the incoming management is often able to achieve dramatic savings in the business's operating costs.

LBOs tend to be mature businesses with a demonstrable record of stable consistent earnings, a significant market share, and experienced in place management. Manufacturing and retailing businesses are attractive because they also contain a basis for asset secured loans or stable income streams for unsecured or subordinated debt. Low capital intensive service businesses are less popular because of their narrow asset bases.

LBOs are said to be attractive to all those involved. Typically, the target concern's top management approaches an investment banker with an LBO proposal. In some cases, specialist banks may take the initiative. The bankers then package an LBO deal, usually involving commercial bankers, insurance and finance companies, pension funds, and the like. The final deal will provide the incumbent management with the opportunity to purchase a stake in the common stock that is much greater than they would be able to obtain on the basis of their individual resources, provided that they can successfully secure the debt. Usually, however, the management group's resources still only provide a small percentage of the initial investment.

This equity gap has led to the creation of a new form of financing known as mezzanine-level finance. Such lenders are often limited partnerships with wealthy investors, venture capitalists, and pension funds as limited partners, supported by an investment banking firm acting as a general partner. In addition to investing in common equity, mezzanine lenders also hold securities senior to management equity but subordinate to secured debt. Most mezzanine financiers are short- to medium-term investors who expect to resell their share of the equity a few years after purchase to realize a substantial capital gain.

LBOs are far from risk-free. First, an LBO offer may serve to attract more bidders, although this is not a problem if the primary objective is to achieve the best value for existing shareholders. Second, and more important, is the risk of insolvency. As revolving bank lending is a primary means of financing LBOs, they are very sensitive to increases in interest rates as a result of their highly leveraged position.

The risk of diversification is also a potential problem. LBO firms tend to be relatively undiversified and from mature industries. The process of diversification, especially from a single business strategy or a dominant business strategy, suffers a high failure rate. Furthermore, as LBOs revert to private status, financial reporting becomes much less transparent than with publicly owned concerns, increasing the risk to lenders.

Research on merger and acquisition activity from 1991 to 2006 has observed how covenant protection (which limits certain actions a company may take) affects the probability of takeovers. In one study of LBOs, the results showed that bond holders with covenant protection benefited from an increase in wealth, while unprotected bonds experienced a higher decrease once the LBO was announced. The presence of bond holder change-in-control covenants reduced the firm's probability of being subjected to an LBO. Change-in-control covenants also decreased the likelihood of non-LBO takeovers (Billett, Jiang and Lie, 2010).

Recent empirical evidence shows that private equity firms are also inclined to investment with less leverage. They are more likely to

Wiley Encyclopedia of Management, edited by Professor Sir Cary L Cooper.

take minority equity shareholding in public or private companies. Private equity firms are becoming more involved in minority equity investments, in the forms of venture capital and international investments. This is commonplace in Asia. More corporate investors are offering additional value without taking full control of an organization. The relatively new mode of operation of private equity firms is increasing the supply for capital for minority investments. (Kaplan and Stromberg, 2010).

See also *acquisition strategy*; *corporate venturing*; *joint ventures*; *mergers and acquisitions*; *post-acquisition integration*

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