Leveraged Buyout

A leveraged buyout is an acquisition financed by much borrowing, in which the new debt is not a liability of the buyer but instead is a liability of the target.

Sometimes the buyer is the executives of the target, who buy the firm from the other stockholders. Alternatively, outside investors (a private-equity company) may be the buyer. Commonly the buyer is not a long-term investor but seeks to resell the company rather soon.

Source of Profit?

Because leverage is high, the profit to the buyer can be very large.

Does the buyer profit because better management has added value? Or does the buyer profit by taking value from others?

When a high profit is made, commonly the buyer maintains that the profit stems from increased efficiency. However this situation need not be the case. Perhaps the buyer has just taken value from others, without any real change in the operation of the firm.

Value Taken from Workers?

Sometimes the buyer profits by firing the workers and then hiring new workers, at lower wages.

Value Taken from Bondholders?

Alternatively, the buyer can profit at the expense of the bondholders.

Example

Consider a simple example. The assets and operations of the company are worth 1000. The firm has bond debt of 500. The bonds have a good credit rating and pay investment-grade interest. The equity of the stockholders is total value less debt, 1000 - 500 = 500.

Leveraged Buyout

The leveraged buyout purchases all the equity from the stockholders, for 500. For simplicity, suppose that this purchase is financed entirely by borrowing. A new bond issue of 500 finances the purchase.

The salient characteristic of a leveraged buyout is that this new borrowing is not a direct debt of the buyer, but instead is debt of the target firm. Because the firm is now very heavily indebted, its financial situation is somewhat precarious. If fortune does not smile on the firm, it will be unable to pay its debt and will be bankrupt. Consequently the new bond issue of 500 is an issue of junk bonds, paying high interest.

Original Bonds

The same situation applies to the original bond issue. These bonds are no longer seen as investment grade, but instead are now junk bonds. Hence the market value of these bonds has fallen.

For example, suppose that the original bond issue has fallen in value from 500 to 400.

Profit

The buyer now has a profit of 100! The firm continues to be worth 1000. The original bond issue is worth only 400, and the new bond issue is worth 500. Hence the equity of the stockholders is 1000 - 400 - 500 = 100.

The buyer has gained 100, at the expense of the original bondholders.

A Different Viewpoint

One can understand the situation from another point of view. What happens later, after the leveraged buyout? Overall, the buyer sees the situation as “heads I win, tails you lose.”

If fortune smiles on the firm, all bondholders will be paid off, and the stockholders make a profit. Their investment is small, so their return on investment is enormous.

If fortune does not smile on the firm, it is bankrupt. The bondholders lose money. The stockholders also lose out, but in a leveraged buyout their investment is small (zero in the example).

The change in the capital structure hurts the bondholders, with a corresponding gain to the buyer.

A defender of the leveraged buyout might respond that indeed the buyer does add value to the firm and does not merely seize it from others. The defender might contend that a seizure of value from the original bondholders plays no role in the profit of the buyer.

However this contention is flawed. If the buyer is a large private-equity company, typically it could buy the target by borrowing directly itself, at a *low* interest rate. Yet it refuses to do so. Instead, it makes the new borrowing the liability of the target company, paying a *high* interest rate and borrowing to the hilt. Why does the buyer choose to pay high interest? The natural interpretation is that the seizure of value from the original bondholders is indeed a central component of the buyer's strategy.

Restrictive Covenant

To protect bondholders, the indenture of a bond issue may contain a restrictive covenant. For example, the covenant might prohibit additional bond issues, to prevent the original bonds from becoming junk.

Big Dividend?

Another possibility is that the buyer profits by paying himself a huge dividend soon after the purchase. The dividend further weakens the financial structure of the firm, which makes bankruptcy more likely. However the dividend ensures a high profit to the buyer. Since 2000, dividends following leveraged buyouts have approached $100 billion.

The mail-order fruit seller Harry and David was subjected to this treatment ([1]). The former owners sold out to a new owner. The new owner quickly declared a big dividend, larger than the purchase price, and before long the firm was bankrupt. The company terminated the pension plan of the workers. The many Oregon farmers who supplied the company lost their market and suffered.

References

[1] James Surowiecki. Private inequity. *The New Yorker*, January 30 2012. 11