Leveraged Equity Recapitalization

By Huxley Nixon

Definition:

A **leveraged buyout** (or **LBO**, or highly leveraged transaction (HLT), or "bootstrap" transaction) occurs when an investor, typically financial sponsor, acquires a controlling interest in a company's equity and where a significant percentage of the purchase price is financed through leverage (borrowing). The assets of the acquired company are used as collateral for the borrowed capital. Typically, leveraged buyout uses a combination of various debt instruments from bank and debt capital markets. The bonds or other paper issued for leveraged buyouts are commonly considered not to be investment grade because of the significant risks involved.[1] If the company subsequently defaults on its debts, the LBO transaction will frequently be challenged by creditors or a bankruptcy trustee under a theory of fraudulent transfer[2]

Companies of all sizes and industries have been the target of leveraged buyout transactions, although 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 stable and recurring cash flows;
- Hard assets (property, plant and equipment, inventory, receivables) that may be used as collateral for lower cost secured debt;
- The potential for new management to make operational or other improvements to the firm to boost cash flows, such as workforce reductions or eliminations;
- Market conditions and perceptions that depress the valuation or stock price.

(Source: Wikipedia)

Background:

This structure was first used by McLean Industries, Inc. in its purchase of Pan-Atlantic Steamship Company in January 1955 and its acquisition of Waterman Steamship Line in May 1955. Malcom Mclean, founder of Mclean Trucking and considered the father of *"containerization"* sold the trucking company for $25 million and created McLean Industries, Inc. to acquire Pan Atlantic and Waterman Steamship companies (in 1955 U.S law prohibited a trucking company from owning a steamship line). McLean issued $7million in preferred stock and borrowed $42 million in bank debt. At closing he used $20 million in cash and assets of the acquired companies to pay down the $42 million in debt. This new financing approach used in a private context did not go unnoticed by others that desired to apply it to public markets. The creation of publicly traded holding companies as investment vehicles to acquire portfolios of investments in corporate assets were popularized in the 1960's by Warren Buffett (Berkshire Hathaway), Victor Posner (DWG Corporation) and others.

In the mid 1960's several Bear Stearns financiers (Jerome Koldberg, Henry Kravis and George Roberts) conceived the boom of leverage buyouts to come in the 1980's by closing a series of what they described as "bootstrap" investments using Bear Stearns balance sheet and their own money. Many founders of private companies that were not large enough to access the public markets, lacked a viable or attractive exit unless they sold to a competitor which most refused to do. Thus, a financial buyer was an attractive alternative for these founders.

By the mid 1970's these aggressive bankers left Bear Stearns to form KKR (1976). Led by KKR the 1980's saw the creation of other Leverage Buyout Firms such as TPG (Texas Pacific Group), Forstmann Little, Blackstone Group, etc. and corporate raiders such as Carl Ichan, Victor Posner and T. Boone Pickens.

The Structure:

The acquirer/sponsor would purchase a control equity position in the target by using its assets as collateral to obtain a (non-recourse) loan (or bond offering) to pay for 50% to 85% of the purchase price. The strategy of the acquirer was to cut out any non essential costs to boost earnings in the near term and reduce the debt as quickly as possible. The ability to use this structure on much larger public (or private) transactions would never have been possible without the creation of the "Junk Bond" or "High Yield Debt" market by Drexel Burnham's Michael Milken that provided the huge amounts of debt required for these transactions.

Typically the acquirer held the company for three to seven years and then would sell when market conditions were right to exit. It might take the company public or do a secondary offering to take their equity out plus a handsome profit as soon as legally possible. As long as the company's cash flow continued to service its debt and market P/E ratios were growing, this strategy worked beautifully.

The LBO reached its pinnacle with KKR's hostile takeover of RJR/Nabisco in 1989 for $31 BN but the deal that caught the eye of Wall Street was achieved by ex Treasury Secretary, Bill Simon's Wesray Corporation acquisition of Gibson's Greeting Cards in 1982. He personally put up approximately $333,000 of the $1 million in equity invested by the new ownership group and when the company went public 18 months later he realized a profit of $66 million!

Unfortunately, many of the very highly leveraged transactions (85% to 95%) completed in the late 1980's failed (i.e. *1988 buyout of Federated Department Stores*) as did the principal originator and supplier of this debt class, Drexel Burnham. Drexel declared bankruptcy in 1990 and Michael Milken went to prison for insider trading, stock manipulation, fraud and stock parking (buying stocks for the benefit of another).

1990's - Coming of Age of Private Equity Groups:

With the reemergence of private equity investors after the recession of 1990 - 1992, recaps began to earn some legitimacy and respect versus the "corporate raiders" and hostile takeovers of the 1980's. Leveraged recaps slowly returned with a new crop of more traditional lenders pulling in the reins on excessive leverage and the private equity investors being more focused on the long term development of the companies they acquired.

The 1990's were the heyday for technology companies and venture capital as well as telecommunications companies emerging with new technologies and service offerings for business and the consumer post breakup of AT&T. This period saw the emergence of more institutionalized private equity firms, ultimately culminating in the massive Dot-com bubble in 1999 and 2000. (Source: Wikipedia)

Equity ReCaps in 2000's:

2000 and 2001 brought the end of the "tech bubble" and the proliferation of Competitive Local Exchange Carriers ("CLEC's") and their flawed business model and brought the LBO market to a standstill. According to Wikipedia's The History of Private Equity and Venture Capital (click here) when leverage recaps reemerged in 2003 debt levels were at more conservative levels. In the 2000-2005 period debt averaged between 59.4% and 67.9% of total purchase price for LBO's in the United States [3]. Additionally, private equity firms were more likely to make investments in capital expenditures and provide incentives for management to build long-term value.

Private Equity firms proliferated from several hundred firms in the early 1990's to approximately 6,000 by 2008. They ranged in size from $25 million SBIC firms to Mega firms such as Bain Capital, TPG (Texas Pacific Group), KKR, Blackstone and Goldman Sachs Principal Investment Group (i.e. KKR has approximately $17 BN in Commitments).

Age of the MEGA- LBO

By 2005, with declining interest rates, loosening of lending standards (i.e. advent of issuer friendly developments including PIK and PIK Toggle (interest is "*P*ayable *I*n *K*ind") and covenant light financing documents) and regulatory changes (Sarbanes-Oxley), records for the "largest buyout" were broken nine times between 2005 and Q3 2007 (Note: while these mega deals were larger on a nominal basis than the 1989 $31.1 Billion RJR deal, when adjusted for inflation, RJR still reigns). In July 2007 the chaos that had reached the mortgage market spilled over to the high-yield/leverage debt markets thus increasing risk spreads and halting this period.

The Great Recession (2009 - ?)

The death of the securitization of the derivative markets and near collapse of the banking system in Q3 2008 virtually killed this market for large deals until mid 2010 (*Burger King Deal announced - closed Q1 2011*). The second half of 2010 and first half of 2011 witnessed willingness by lenders to start lending again on private equity sponsored deals; however, on much more rigorous lending standards. The author believes uncertainty about the US economic recovery, paralysis in Washington to deal with the Federal Debt and Jobless recovery and global economic chaos means debt markets will unlikely return to the GO-GO days of the 1980's, 1990's and 2005-2007 era for a long time. Q3 and Q4 of 2011 saw a slowdown in deal activity and retightening of standards by lenders but with the huge supply of available funds to invest by strategic, financial buyers and lenders plus a favorable tax environment Ernst & Young predicts a more active M&A Market for 2012.

Is the Leveraged Recap Suitable for Lower Middle Market?

Yes! If your company meets the following criteria:

1. History of sustainable CASH FLOW.
2. Operates in a GROWTH industry or industries.
3. Existing leverage (debt) is modest.
4. Have hard (tangible) assets that can collateralize lower cost secured debt.
5. DIVERSIFIED Customer base.

In today's debt constrained market environment for private middle market transactions (below $1 BN in Enterprise Value), debt structures are much more conventional (Senior Bank debt + Mezzanine) and it is normal for the equity sponsor to invest 40% to 50% of the purchase price.

Potential Dangers:

1. Excessive Leverage/ Debt post closing that Company Cash Flow cannot support.
2. Causes management to focus on short-term goals of reducing debt vs spending on future growth (capital expenditures, R&D, etc.)

The Wikipedia definition at the beginning of this article for a *"Leveraged Equity Recapitalization"* does NOT accurately describe the market as it exists today (i.e. **LBO**, or highly leveraged transaction (HLT), or "bootstrap" transaction).

The major cause of LBO failures in the past, excessive debt, is highly unlikely in our current debt constrained environment. With more conservative capital structures a company that has undergone an "Equity Recap" should have cash flow to support capital expenditures and be able to handle an unexpected bump in the road or grow through acquisition post closing. However, because of the failures in the 1980's and 1990's, some creditors and bankruptcy courts claimed they were "Fraudulent Transfers" of the company's assets and these deals failed as a direct result of the excessive leverage occurring as a result of over-optimistic forecasts. Regardless of this possibility, the *U.S. Bankruptcy Code includes a so-called "safe harbor" provision, preventing bankruptcy trustees from recovering settlement payments to the bought-out shareholders.* The author believes if today's debt as a percentage of the purchase price remains below 70% this issue should not be a real risk to the recap equity participants (but the reader should consult with their attorney and other advisors for legal and market advice).

Summary:

If you are the owner of a private company, meet the suitability criteria mentioned above and:

1. Desire to monetize a majority of your equity value created while retaining a meaningful equity stake in your company,
2. You are NOT ready to "walk away" and retire,
3. Desire to retain Operating Control,
4. Partner with a Strong financial partner to grow company,
5. Exit in 5 to 7 years with the possibility to realize a "second" payday.

You should explore the Equity Recap alternative! Read more … see Huxley's Blog www.sellyourcompany.org *"Is an EQUITY RECAP right for MY Company?"*

Author: Huxley Nixon has been involved in M&A (mergers and acquisitions) for 35 years as a buyer, seller and intermediary. He is founder of the M&A MARKETPLACE by CHC (www.mamarketplace.com) where the buyer pays all success fees and the process is only 120 days. For owners of private companies considering a sale of part or all of their company – it provides a very quick, confidential and **competitive** alternative to current options less transparent and more disruptive for the owner.

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