LEVERAGE BENEFITS: WHAT ARE THEY AND WHY ARE THEY SO POPULAR?

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INTRODUCTION

When I originally began this project, I intended to first find out exactly what a leveraged buyout was and how it worked. Why are they so popular these days and what are the methods used to complete such a seemingly overwhelming task? Second, I hoped to apply these findings to an actual buyout of a company and see how the theory was applied and what the results were.

The first part of the project was not difficult, only time-consuming. LBO’s have become the latest fad in the financial world and the process has been well-documented in the past two or three years. The second task turned out to be nearly impossible. The first (and most easily overcome) difficulty was choosing a company to follow. Originally, I chose Signetics, Corp. due to the incredible amount of debt generated by its buyout. From its original level of $82.5 million, Signetics's debt rose to $422 million. I believed this could possibly pose some interesting problems for the company after the buyout was completed. However, as I looked for material regarding Signetics's actions, I found no information pertaining to the LBO. As a result of the lack of information, I decided to switch companies and look elsewhere. Dr Pepper became my next target. I had read that Wall Street believed it to be one of the biggest buyouts, up to that point. Surely some information would be available.

Unfortunately, it was not to be so. No matter where I searched, little information was to be found. I gradually realized what the problem was. The whole point behind an LBO is to buy up all the public stock of the company so that it is privately controlled. Private com-
panies have no legal obligation to release information to the public. No matter what company I researched, I would find it difficult to obtain the information I needed (i.e., what happened in the years immediately following the buyout?) Mr. Pepper was also a poor choice in that the buyout was friendly (not opposed by its senior management). The Wall Street Journal and other business periodicals did little more than report the basic facts of the deal. At this point, I no longer had the time to research yet another company. Therefore, I present here my basic research in the hope that it will be informative to those who have no background in this area. The Mr. Pepper information (such as it is) is included to give a basic idea of the amount of funds needed for this type of business deal and also why an LBO was considered appropriate.
Although leveraged buyouts have only come to the attention of the public in the last six years or so, they have existed for far longer than that. In the early 60's, LBO's were known as "bootstrap" financing. It was not until the mid-70's that the term "leveraged buyout" was coined. Until the late 60's-early 70's, LBO's were used infrequently and only for small companies or divisions. However, as the trend towards conglomerates grew stronger, the advantages of the LBO became much more apparent. A conglomerate consists of many diverse companies which often have no relation to any of the other companies. At times, some conglomerates find themselves owners of a company or a division which is doing them more harm than good. They therefore decide to sell it off to some interested party. One of the preferred methods of sale is the LBO.

A very basic definition of an LBO is a group or individual buying up the public shares (ownership) of a company in order to take it private. Also, private companies may be purchased by other private companies, or a division of a public company may be sold to a group of private investors who wish to form their own company. The manner in which the purchaser raises the money to buy the shares is why the process is called a "leveraged" buyout. The most often used method of financing is debt. Typical sources of funds include banking or investment firms, an employee stock ownership plan, pension funds, a group of individual investors, the personal finances of the present management and/or insurance companies looking for a hedge against inflation. Often, funds are obtained from a combination of the sources above. Each buyout
has its own unique method of leveraging the deal and new ways are being developed with each transaction.

In order to borrow the money, the assets and projected cash flows of the company being purchased are used as the collateral, similar to buying a house with a mortgage. The more money which is borrowed, the more leverage results. With more leverage, the rate of risk increases. Risk is the major concern when considering a leveraged buyout. Risk results because of several factors inherent in the transaction. Many experts feel that LBO's reduce the competitive strength of a company. The huge debt which is taken on requires the company to be profitable immediately. Therefore, the company is unable to make the large expenditures on advertising and research and development which are usually necessary to stay competitive over the long run. The capacity for innovation is also limited by the amount of debt. No time can be spared to "wait and see" if something will be successful. It must be profitable immediately. The stability and earnings of a company can be destroyed in the attempt to reduce the level of debt. Minor swings in profit can have devastating consequences due to the leveraging effect. Also, cash balances are low, cutting the length of time a company can weather a downturn in business. Risk also decreases the flexibility of the company. Due to the high leverage, one small change is magnified many times over. Small profits become large profits, but small losses are also magnified into large ones. The company can no longer change blindly in and hope for the best. Every move must be considered carefully as to its end results. Also, managers of companies with high debt may be tempted to use quick fixes strategies rather than planning for the long run. Opportunities which come only once every five or ten years may be missed because of
the overwhelming need to make immediate profit. Finally, there is always a risk that the company will be caught paying high rates of interest while inflation falls. Profits will go towards paying off debt rather than to the owners.

One version of an LBO which reserves greater debt capacity for the future is an asset-based LBO. In this case, debt is borrowed only upon the liquid value of present assets rather than assets plus projected cash flows. Because sales volume, inventory, and cash collections need to be monitored in order to insure their stability, this method usually costs 1-2\% more in interest than the others. However, this method allows the company more flexibility in the amount it will be able to borrow in the future. As inventories and receivables increase, the company is able to borrow more money due to its increased asset base. This helps to eliminate the problem mentioned earlier of the inability to spend on advertising, research and development, etc. and/or to ride out an economic recession.

The third method discussed here is the net operating loss LBO. The purpose of this method is to shelter the earnings of the acquired company from taxes in order to repay the debt more easily. This method involves one company suffering from lost income buying out another company, but instead of absorbing the purchased company, a partnership is formed. The purchasing company then carries over its losses onto the other company's books for tax purposes. One risk of this method in addition to the others is that if the acquired company does not make a profit, the purchasing company will be stuck with twice the losses that it had before with no way to repay the debt. Approximately 10\% of all LBO's follow the net operating loss method. Although already limited
by Congress to some extent, further restrictions in the future could include limiting the carry overs to off-setting the income loss an acquiring company might have had if no acquisition had occurred. 5

LBO's have been growing at a fantastic rate. In 1977, transactions through LBO's amounted to about $64 million dollars. In 1982, they totaled $1.4 billion and in 1983, $8.1 billion dollars. Many individual deals are now for $500 million and up. Why have they become so popular? One reason is that LBO's are usually a private matter between the company being sold and a few prospective buyers. The hassle and embarrassment of a public bidding match is avoided. 6 Also, lower profits can be reported for tax purposes due to the high interest expense, and the upward reappraisal of the value of the assets creates much greater annual depreciation charges. Firms are able, on the average, to avoid paying any taxes for five years. Many also feel that LBO's give the U.S. a better competitive position in world markets. Japan and other foreign countries have highly leveraged balance sheets and the U.S. must increase its leverage also in order to compete.

Companies are also more eager to sell now than they were in the past. Many industrials need to sell off various divisions for cash to help stabilize their balance sheet. 7 LBO's make this relatively quick and easy to do. Also, interest rates have been falling lately, making such huge debt purchasing more feasible. Many companies sell themselves because they are experiencing trouble competing in the industry. Dr. Pepper was losing its identity because it could no longer compete with the huge campaign budget of Coke and Pepsi. They had also recently acquired Canada Or's and could not handle the debt load. Therefore, they allowed themselves to be purchased by Pepsico a few years ago.
In order to gain access to more cash, 5

As the number of sellers has grown, so too has the number of buyers.

In LBO's, it seems everyone profits. Shareholders often receive a higher-than-market price for their shares and junior and senior creditors receive payment for debt they never expected to see because the company was failing. As a result, these groups usually are supportive of the sale. The real winners, however, are the managers of the company on division and the other major investors. Often, the managers either purchase the company themselves or are given the opportunity to stay on as managers and share in the profits. These managers have worked in the division, know what is going on, and once given free rein, are able to do things they could not do before because it did not fit with the overall company goals. 3

The number of buyers has also increased because regular mergers and acquisitions do not appear to be as successful as they once were. Promises of synergy have not been realized and the financing is much more expensive. 10 LBO's offer many more opportunities for growth and profit. LBO's allow for recapitalization and revaluation of assets allowing the owners to take maximum advantage of tax and accounting laws. 11 Also, with LBO's, efficiency is usually greatly increased. Because huge debts must be repaid, managers are forced to cut operations to the bone. No more huge expense accounts or luxuries can be allowed because there is no other company to fall back on. Also, the managers work for themselves. When they become more efficient, they earn more profit for their own benefits rather than for someone else. 12 Returns are often 40% or higher for many of those involved. Mr. Pepper was able to increase its resource strength and also concentrate upon the basics
of business rather than trying to please the stockholder. Sales have improved greatly since it was taken private. Efficiency has also been improved.\textsuperscript{15}

As with everything in the world, LBO's are not perfect. When a company takes on as much debt as an LBO requires, it is beholden to its bankers in many ways. Banks could insist that the company cut its inventories in order to free up cash. While this helps the company repay its debts more quickly, it could also hurt customer service. Customers who must wait for delivery once too often may find someone else who can deliver on time.\textsuperscript{14} High debt also gives banks more power to take demands than equity holders. Banks are concerned with immediate cash flow in the short term rather than growth in the long run. Such thinking may cause a company to be profitable for five to ten years but fail after that due to lack of capitalization and long term strategies.\textsuperscript{15} In addition to problems with the bank, companies may find suppliers to be reluctant to continue in their present capacity. They may fear that they will not be paid because the company's first responsibility is to its major creditors.

The problems associated with LBO's, especially those of risk, may be lessened by choosing an appropriate company. The best targets are those in a mature industry. These companies traditionally have the predictable future cash flows which are necessary to repay debt. They usually have an abundance of cash which can be stripped off to either be used by the company or to help repay debt. Also, mature companies have well-established product lines. This means that less money will have to be spent on advertising and research and development. Unlike high tech or growth industries, it is less likely that a new development will occur that will change the whole industry and cut into earnings.\textsuperscript{16} Prior
to the boycott, the company should have very little debt that must be paid off. Leonard Saxton of Citibank further recommends that the company have revenues of at least $50–100 million a year in order to insure that the company can weather bad times. Other necessities are that the company be secure in its own market niche, fighting for market share would require a great amount of cash that is needed elsewhere. Finally, the current management team, if not involved in the purchase, must agree to stay. Since the company must become very efficient, very fast, it is essential that there be no confusing changes of control at the top. Continued management by the same team will reassure employees that the company will continue to exist and that they can expect to keep their present jobs.

A major consideration of whether to use LBO or not is if the company can handle the high interest payments. These payments can sometimes equal almost 30% of the total purchase price. Most companies today borrow money with a floating interest rate. As the market rate rises and falls, so too does the interest rate of a particular company. In times of rising inflation, floating rates can almost bankrupt a company. One way to minimize this is by negotiating a cap on the floating rate. A cap allows the floating rate to increase to a certain level and no higher. Should the market rates reach this cap and go still higher, the floating rates will only go as high as the cap. The difference between the higher market rate and the cap is added onto the principle, giving the company an extended period to pay. This policy saves the company from default and the bank from nonpayment. In cases where there is no cap and the rate keeps climbing higher, banks will agree to lend more money to help meet the interest expense. In times of falling inflation,
companies must remember to consider the future before agreeing to a floating interest rate. As long as inflation continues to fall, the company will benefit. However, should inflation begin to increase, a company which neglected to negotiate a cap on its rate may find itself unable to meet its obligations. 13

Once a company has decided to purchase another, it should begin carefully selecting what company it will buy. Listed below is the basic process of how to complete a leveraged buyout. The steps do not necessarily have to be completed in a specific order depending upon the circumstances surrounding each individual transaction.

1. Select target—choose a company which fits your needs/ resources. As mentioned earlier, stable, mature companies are better risks than high growth companies.

2. Conduct business analysis—review the financial and operational trends in the target and its industry. What are the predictions for the future, how well does it fit the direction your company wants to head for?

3. Consider the legal and tax environment—what method of acquisition is best: asset leverage, net operating loss, high debt, or some meld of other than those?

4. Formulate purchase price—how much do you wish or are able to pay? What is your upper limit?

5. Identify working financing plan—what can assets generate, how much debt can be supported, how much equity do the buyers have access to?

6. Discuss viability of plan—is it feasible at this time or should you wait? Will it help your company or drag it down? Will the other company agree?

7. Make the initial offer.

8. Investigation by each party—does additional information change any of your earlier reassessments? Do they feel you are the right company or would they rather wait for further offers?

9. Closing
Once a buyout is completed, it must be protected from failure. A certain amount of cash should be held in reserve to be available if needed in an emergency. Enough money should be left over to allow for capital investment to remain competitive and enough working capital should be available to allow some type of growth. Also, once the company has been adjusted to its new position, it should begin to repay debt as quickly as possible while still leaving enough funds available for capitalization and growth. The most important measure to take in order to protect a buyout is to plan for everything in advance. The company which jumps in without definite courses of action for future needs is almost assured of ending up bankrupt. There is too much debt and risk involved to do things haphazardly.21

Once a buyout is complete and the company is operating successfully, the only remaining task is to complete the repayment of debt and achieve full liquidity. Most companies prefer to repay their debt as goods are sold rather than in one annual lump payment. This helps to reduce interest charges more quickly and encourages the company to work even harder. Companies may also sell off certain assets in order to generate funds for debt repayment.22 In the case of Dr. Pepper (no pun intended), soon after its purchase, it sold off its Canada dry subsidiary to help pay debt, and was considering spinning off some of its bottling plants to reduce its cash requirements.23 Once a company has repaid much of its debt, it may consider going public again. To do this, it can either offer shares publicly or merge with a public corporation. Also at this time, the company may repurchase the shares of the corporation still held by its private investors.24

In order to give a better idea of why a company would sell, the
Information concerning the Dr. Pepper buyout is presented below. In 1981, believing it would help increase its market share and its earnings, Dr. Pepper purchased Canada Dry for $155 million or five times its 1981 earnings which it must begin to repay by 1985. However, this action caused Dr. Pepper to be chronically short of cash. As a result, advertising slipped and Dr. Pepper was unable to pay as much attention to its bottlers. Meanwhile, Coke and Pepsi were fighting for the number one position and affecting the entire industry. Because of its reduced advertising, Dr. Pepper lost its third place position in the soft drink industry to 7-Up. It also began to lose bottlers to other companies, causing its area of distribution to shrink.25

By the third quarter of 1982, its earnings were down 70%. At the beginning of 1983, its sales were up 27%, but profits were down 27%. It was obvious that Dr. Pepper could not continue in its present condition. The main problem appeared to be the added debt it had taken on from its Canada Dry acquisition. In 1983, W.W. Clements, president, hired Donald Peers & Co., an investment banker, to study ways of getting critically needed cash.26 At this point, the question of selling the company had already been raised. The debt structure consisted of:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>Canada Dry acquisition</td>
<td>$155 m</td>
</tr>
<tr>
<td>Canada Dry debentures</td>
<td>$94.8 m</td>
</tr>
<tr>
<td>Repayment of Canada Dry bonds</td>
<td>$18.8 m</td>
</tr>
<tr>
<td>Total</td>
<td>$188.6 m</td>
</tr>
</tbody>
</table>

On February 15, 1984, an advertisement appeared in the Wall Street Journal, urging stockholders to vote "yes" for a buyout of Dr. Pepper by PaineWebber Little & Co. The terms of the deal were $27 per share and a dividend of $1 per share. A two-thirds "yes" vote of the outstanding shares was required in order to proceed. The company stated that no other offers had been received at that time and that independent advise
felt it was a fair price. Market price per share had been running at about $21.75. The two-thirds vote was received and February 28 was the last day Dr. Pepper was traded on the New York Stock Exchange.

Wall Street called it one of the biggest buyouts ever and also one of the most likely to fail. Immediately following the sale of Dr. Pepper, its Canada Dry subsidiary was sold to A.J. Reynolds Co. to generate cash for debt repayment. Following the buyout, its debt level had risen to $62 million. Two of its bottling plants were also sold with more to follow. Management at Dr. Pepper feels the buyout was a good move that increased its resource strength and allowed the company to get back to basics. The company will probably go public again if earnings are up and the owners can get a good price. So far, they have done a good job. Earnings are up for 1994 and the future looks promising.
Leveraged buyouts are not for everyone. Only those companies which plan carefully and have taken the necessary precautionary measures should attempt one. The major ways to finance a buyout are with debt based on assets, assets and cash flows, and on operating leases. The chances for profit are great. Often, investors receive 40% return on their investment while others have received a 100% or more return. LBO’s allow companies to take advantage of certain tax breaks in regard to interest expense and depreciation. Firms can usually avoid taxes for five years or more. Greater productivity and efficiency also result. The most significant problem connected with LBO’s is the high level of debt required and the risks this entails. For this reason, the best targets are mature, stable companies with substantial cash balances and revenues. Companies which negotiate a floating interest rate should be sure it has a cap to avoid paying outrageous interest expense should inflation increase.

Although LBO’s were predicted to end in disaster from the beginning, it has not been so. Investors are becoming much more careful and the business has calmed down considerably. Fears about what would happen during a recession were disproved in the late 70’s and early 80’s. The main rule which all involved in LBO’s should remember is plan and plan some more. Knowing what is going on in the industry and how it will affect the business deal is half the battle. Careful planning greatly improves the chances for success.
6. Thackray, p. 31.
7. Gabor, p. 45.
10. Sandler, p. 49.
11. Thackray, p. 32.
19. Sandler, p. 69.
22. Soder, p. 46.
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"Dr. Pepper Tries a Local Cure," Business Week, December 13, 1982.


