Corporate Restructuring

Chapter 33

What is a leveraged buyout (LB0)?

- In an LBO, a small group of investors, normally including management, buys all of the publicly held stock, and hence takes the firm private.
- Purchase often financed with debt.
- After operating privately for a number of years, investors take the firm public to “cash out.”

Leveraged Buy-Outs

Unique Features of LBOs

Large portion of buy-out financed by debt

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Shares of the LBO no longer trade on the open market

Leveraged Buy-Outs

Potential Sources of Value in LBOs

- Junk bond market
- Leverage and taxes
- Other stakeholders
- Leverage and incentives
- Leverage restructurings
- LBOs and Leverage restructurings

Leveraged Buy Outs

10 Largest 1980s LBO’s + recent examples

Industry	Acquirer	Target	Year	Value ($ billions)
Food, tobacco	KKR	RJR Nabisco	1989	$24.7
Food	KKR	Beatrice	1986	6.3
Glass	KKR	Owens-Illinois	1987	4.7
Supermarkets	KKR	Safeway	1986	4.2
Convenience stores	Thompson Co.	Southland (7-11)	1987	4.0
Airlines	Wings Holdings	NWA, Inc.	1989	3.7
Utilities	TPG, KKR	TXU	2007	45.0
Real estate	Blackstone Gp	Equity Office Properties	2007	38.9
Healthcare	Bain Capital, KKR, Merrill Lynch Global Private Equity, Thomas First	HCA	2006	32.9
Credit card processing	KKR	First Data	2007	29.0
Pipelines	Management, several private-equity groups.	Kinder Morgan	2007	21.6
Radio	Thomas Lee, Bain Capital	Clear Channel Communications	2007	19.4
Semiconductors	Blackstone Gp, Carlyle Gp, Permira Advisers, TPG	Freescale Semiconductor	2006	17.7

What are the advantages and disadvantages of going private?

- Advantages:
  - Administrative cost savings
  - Increased managerial incentives
  - Increased managerial flexibility
  - Increased shareholder participation
- Disadvantages:
  - Limited access to equity capital
  - No way to capture return on investment

Definitions

- ***Corporate control*** -- the power to make investment and financing decisions.
- ***Corporate governance*** -- the role of the Board of Directors, shareholder voting, proxy fights, etc. and to actions taken by shareholders to influence corporate decisions.
- ***Financial architecture*** -- the financial organization of the business.

Leveraged Buyouts

- The difference between leveraged buyouts and ordinary acquisitions

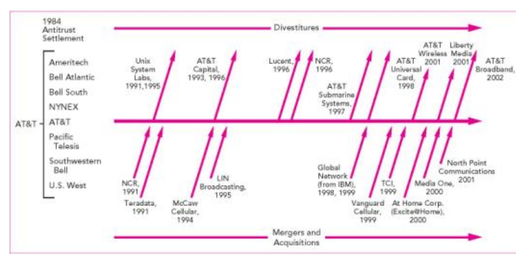
1. A large fraction of the purchase price is debt financed.
2. The LBO goes private, and its share is no longer trade on the open market.

Leveraged Buyouts

- The three main characteristics of LBOs

1. High debt
2. Incentives
3. Private ownership

AT&T Breakup Saga



What are the major types of divestitures?

- Sale of an entire subsidiary to another firm.
- Spinning off a corporate subsidiary by giving the stock to existing shareholders.
- Carving out a corporate subsidiary by selling a minority interest.
- Outright liquidation of assets.

What motivates firms to divest assets?

- Subsidiary worth more to buyer than when operated by current owner.
- To settle antitrust issues.
- Subsidiary's value increased if it operates independently.
- To change strategic direction.
- To shed money losers.
- To get needed cash when distressed.

Spin-offs, etc.

- ***Spin off*** -- debut independent company created by detaching part of a parent company's assets and operations.
- ***Carve-outs***-- similar to spin offs, except that shares in the new company are not given to existing shareholders but sold in a public offering.
- ***Privatization*** -- the sale of a government-owned company to private investors.

Privatization

- Motives for *Privatization*

1. Increased efficiency
2. Share ownership
3. Revenue for the government

What are the major causes of business failure?

- Economic factors
  - industry weakness
  - poor location/product
- Financial factors
  - too much debt
  - insufficient capital
- Most failures occur because a number of factors combine to make the business unsustainable.

Do business failures occur evenly over time?

- A large number of businesses fail each year, but the number in any one year has never been a large percentage of the total business population.
- The failure rate of businesses has tended to fluctuate with the state of the economy.

What size firm, large or small, is more prone to business failure?

- Bankruptcy is more frequent among smaller firms.
- Large firms tend to get more help from external sources to avoid bankruptcy, given their greater impact on the economy.

What key issues must managers face in the financial distress process?

- Is it a temporary problem (technical insolvency) or a permanent problem caused by asset values below debt obligations (insolvency in bankruptcy)?
- Who should bear the losses?
- Would the firm be more valuable if it continued to operate or if it were liquidated?

Key Issues

- Should the firm file for bankruptcy, or should it try to use informal procedures?
- Who would control the firm during liquidation or reorganization?

U.S. bankruptcy

- Chapter 11: Business reorganization guidelines.
- Chapter 7: Liquidation procedures.

- Voluntary bankruptcy: A bankruptcy petition filed in federal court by the distressed firm's management.
- Involuntary bankruptcy: A bankruptcy petition filed in federal court by the distressed firm's creditors.

List the priority of claims in a Chapter 7 liquidation.

- Secured creditors.
- Trustee's administrative costs.
- Expenses incurred after involuntary case begun but before trustee appointed.
- Wages due workers within 3 months prior to filing.
- Unpaid contributions to employee benefit plans that should have been paid within 6 months prior to filing.
- Unsecured claims for customer deposits.
- Taxes due.
- Unfunded pension plan liabilities.
- General (unsecured) creditors.
- Preferred stockholders.
- Common stockholders.

Other Motivations for Bankruptcy

- Normally, bankruptcy is motivated by serious current financial problems.
- However, some companies have used bankruptcy proceedings for other purposes:
  - To break union contracts
  - To hasten liability settlements

Some Criticisms of Bankruptcy Laws

- Critics contend that current bankruptcy laws are flawed.
- Too much value is siphoned off by lawyers, managers, and trustees.
- Companies that have no hope remain alive too long, leaving little for creditors when liquidation does occur.
- Companies in bankruptcy can hurt other companies in industry.