The Advisor – Winter 2015

Leveraged Buyouts

A leveraged buyout ("LBO") is a method used to finance a business acquisition. Specifically, the buyer uses debt to purchase the equity of the business.

This technique has been around since the early part of the 20th century but became popular in the 1980's. By far the most famous and largest LBO at the time was the acquisition of RJR Nabisco by Kohlberg, Kravis & Roberts. The transaction spawned a book (*Barbarians at the Gate*) and a movie of the same name.

Good candidates for an LBO have the following characteristics:

1. **Strong stable cash flows.** Cash flows that are consistent throughout the year are crucial to ensure adequate funds are available to service the debt issued to acquire the business.

2. **Unused debt capacity.** A company that has assets on its balance sheet that are unencumbered by old debt allow for the greater use of new debt to acquire the business.

3. **Redundant assets.** Assets that are not required post acquisition can be sold with the proceeds used to reduce the acquisition debt. Examples include a redundant head office or a business division which is not part of the go-forward strategy of the buyer.

4. **Capital intensive businesses.** Companies with tangible assets that are unencumbered with old debt (e.g. manufacturers, construction, real estate) are easier to "lever up" than service businesses since the new debt can be secured with tangible collateral. This asset-based financing reduces the risk (and cost) of the new debt.

There are a number of entities that use this financing technique to acquire businesses. Although their description implies "equity" investments, private equity firms usually look to maximize the debt portion of any investments they make in new businesses. This is due to a number of reasons:

1. It insures a reasonable return on investment. Debt generates ongoing interest income and provides a stable return vs. equity which may not generate any return if the business is not successful.

2. Debt is cheaper than equity and easier to raise.

3. Interest on the debt is tax deductible by the target, which increases the value of the equity portion of the investment.

4. Interest costs on acquisition debt will usually eliminate excess funds in the target and force management to be disciplined and efficient with their use of cash.

LBO financing can also be used by existing managers of a company to acquire the business. This is known as a management buyout and has been discussed in detail in a previous newsletter.

In addition to an outright sale, an owner may simply want to take some "chips off the table" and only sell a portion of the business. This can be facilitated by way of an LBO as well.

Businesses that are not capital intensive can still use an LBO to facilitate a sale through the use of mezzanine or subordinated debt. These lenders rely solely on the cash flows of the business as collateral. Given there are no tangible assets available, the risk to the lender of non-payment is greater in the event of a business failure. The interest cost on sub-debt is therefore higher when compared to asset based lending. In addition, sub-debt lenders often require equity "sweeteners" in the form of warrants to improve the ROI relative to the risk assumed.

Owners considering a sale in the next three to five years should consider taking a number of actions to improve the business's attractiveness to maximize returns at the eventual sale date. These would include:

1. Stabilizing cash flows so that they are not seasonal in nature.

2. Improving cash flows by increasing margins, cutting costs, etc. and

3. Reducing debt in order to increase debt capacity that can be used by potential buyers.

Aries Advisory Group can assist you with the sale of your business. Even if you are not ready to sell today, we can provide you with a strategy so that your business will be sale ready and more appealing when it comes time to sell in the future. We can then facilitate the sale on your behalf ensuring that all of your goals and objectives are achieved. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.