CHAPTER 1

What is an LBO?

1.1 THE MAIN FEATURES OF AN LBO

1.1.1 Definition

An LBO is an acquisition technique that allows an investor (also called a *sponsor*) to buy a target company using a large amount of debt. The buyout is structured using an intermediary company established for the sole purpose of acquiring the target company. That intermediary is an investment vehicle and does not have any employees. It is commonly referred to as an SPV (special purpose vehicle), SPC (special purpose company), or SPE (special purpose entity).

This SPV, which we will refer to here as the *holding company*, or *HoldCo*, is financed by debt and equity. The exact split between the two depends on the type of target company but also on market conditions at the time of the transaction. The equity is contributed by the buyer interested in the target company while the debt is provided by banks or investors who specialize in debt instruments.

Once taken over, the target company becomes a subsidiary of the HoldCo. The debt is repaid by the dividends paid by the target company. Here lies the magic of an LBO: a buyer can acquire a company while contributing only to a small part of the total amount of the target company value. The balance is supplied by lenders. Figure 1.1 represents a typical LBO structure.

1.1.2 Debt Sizing

Lenders in an LBO take the risk that the target company does not pay enough dividends to repay the debt. The loan provided to the HoldCo is said to be *non-recourse*, meaning that in case of default, lenders have no recourse to the sponsor. In other

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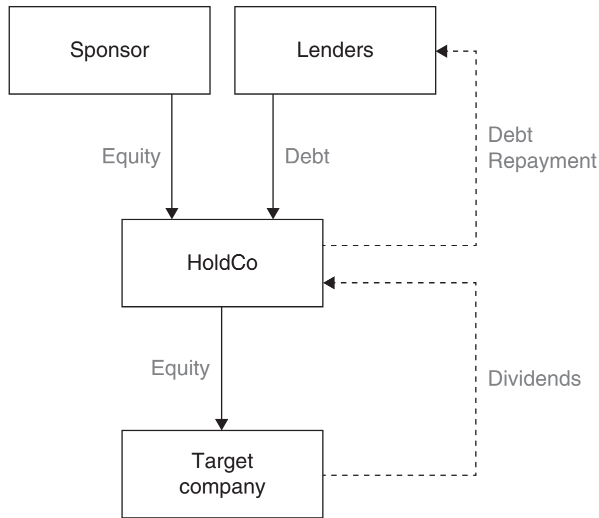

FIGURE 1.1 Simplified LBO Structure

words, lenders do not benefit from any guarantee nor any other type of credit protection from the equity investor. If the target company cannot pay dividends due to underperformance, lenders cannot go to the sponsor and ask for indemnification. Lenders generally only rely on a pledge of the shares of the HoldCo and the target company (a set of securities called a *security package*). These pledges can be exercised in case the HoldCo is unable to repay the debt. This allows lenders to take control of the companies and try to restructure the transaction or sell the target to repay their loan.

Given the risks, interest rates applicable to LBOs are usually higher than those of traditional corporate financing. To ensure that the target company will distribute enough dividends to repay the debt, lenders size their contribution based on the predicted profits or cash flow of the target company:

- For the acquisition of very small companies (turnover of a few million US$ or below), the total debt amount is usually expressed as a multiple of net profit.
- For larger acquisitions, the acceptable level of debt is expressed as a multiple of EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization). EBITDA equals revenues minus operating costs. It is a measure of the operating profitability of a company regardless of its financial strategy, its tax position, or its investment policy. It is a very good indicator of the potential of a particular company and a pertinent reference to use when it comes to debt sizing in an LBO.

1.1.3 Various Types of LBOs

Behind the generic term of LBO, other acronyms are sometimes used to refer to some specific types of leveraged buyouts.

- An MBO (management buyout) is an LBO in which the management of the target company takes part in the buyout, alone or alongside another sponsor. MBOs are a very common form of LBO. They usually happen when:
  - the owner of a small or medium-sized enterprise (SME) retires and decides to sell his or her company to the managers who have worked with them for some time (typically their children or right-hand man);
  - a company is acquired by an LBO firm[1] that wants to retain existing managers. Many LBO firms can offer attractive packages in terms of stocks to key people in the target company. This is a way of aligning the managers' interests with their own interests. These key people are directly incentivized to help grow the company and ensure a successful LBO.
- An MBI (management buy-in) is an LBO in which the buyers did not work for the target company before the acquisition, but act as managers after the acquisition. MBIs are common when the founder of an SME retires and cannot find a new buyer among his or her employees. In this case, the company is put on the market and acquired by a buyer with no previous connection to the company. An MBI can be carried out by a manager alone, by a group of managers, or by one or several managers co-investing with an LBO firm.
- A BIMBO (buy-in management buyout) is a mix of the two previous approaches. It is a buyout in which existing managers and managers from outside the target company collaborate to buy out the target company. Here again, the buyout can be carried out by these managers alone or alongside an LBO firm. A BIMBO generally makes sense if the new managers bring expertise that the existing ones do not have but that is key to further developing the company.
- Finally, a *build-up* is an acquisition carried out by a company that is itself already under an LBO. The new target is in this case usually directly acquired by the original target by adding debt (and sometimes also equity) at the HoldCo level. A merger between the two companies can follow if this makes sense.

1.2 A THREE-STEP LEVERAGE

Contrary to what the reader might think at this stage, leveraged buyouts are not only financing structures. They are transactions implying a high level of tax optimization and that can only bear fruit if the strategy implemented by the new owner works. In other words, LBOs are said to be based on a triple leverage: *financial*, *tax,* and *managerial*.

[1] An LBO firm is an investment company specialized in the acquisition of companies via LBO. Its goal is to buy target companies, manage them, and sell them later at a profit. We will explain in detail in Chapter 2 how these investment firms operate.

1.2.1 Financial Leverage

Of the aforementioned three types of leverage, the financial kind is the easiest to grasp. It is defined as the use of debt to finance the acquisition of the target company. Debt gives more firepower to sponsors and allows them to increase the impact of their equity contribution. They can take control of a company while investing (relatively) little capital. Leverage is generally expressed as a multiple of the target company's EBITDA, as we mentioned before (4 x EBITDA, 5 x EBITDA, etc.).

Financial leverage is a fascinating tool. It boosts shareholders' returns when things go well but can also sting equity investors in case of a market turnaround – especially if debt levels are too high. The risks and rewards associated with financial leverage are pretty high. Sponsors do not have to commit a lot of capital to acquire a target but are exposed to the risk that there might not be enough dividends to service the debt. In other words, sponsors are not only exposed to the risk of the target company not performing; they are exposed to the risk of the target company not performing well enough. The history of LBOs is full of examples of target companies generating profits but of HoldCos incapable of repaying their debt.

1.2.2 Tax Leverage

Tax leverage is the second element that contributes to the performance of an LBO. This second leverage means that after the acquisition, the sum of the taxes paid by the HoldCo and the target company is lower than the amount of tax paid by the target independently before the acquisition.

With each country having its own tax rules, the precise impact of this leverage varies from one jurisdiction to another. It relies, however, on two tax provisions that exist in many countries: (i) the specific taxation system applicable to dividends, and (ii) the deductibility of interest.

1.2.2.1 Little to no Dividend Tax

Dividends paid by a company to its parent are in many countries taxed at a significantly lower rate than other revenues. They can sometimes even be tax exempt. This is mainly because dividends are paid from the after-tax profits of a company. In other words, they arise from profits that have already been taxed. It would make little sense to tax profits at the level of a subsidiary and tax them again when they are distributed under the form of dividends to a parent.

To avoid a double tax impact, many countries have introduced provisions limiting the taxation of dividends paid by a company to its parent. This limit can be integral (dividends are distributed free of tax) or partial (dividends are taxed at a lower rate or only a small percentage of the dividends are taxed).

There are sometimes more detailed rules about the applicability of this favorable tax treatment. The specifics obviously vary from one country to another: The parent company can, for instance, be required to own at least a minimal percentage of the subsidiary or commit to holding an equity interest in the company for a given period.

1.2.2.2 Tax Groups and Interest Deductibility

Many countries have designed specific tax provisions for companies belonging to the same group. These provisions generally allow them for tax purposes to pool all the financial results of the group's subsidiaries at the level of the parent company. This allows a group to offset the profits made by some of its subsidiaries with the losses of its non-performing entities. The concept of tax grouping can take many forms, depending on the tax system of the country where the group of companies is located. It can be optional or mandatory. It may require the parent to fully own the subsidiary or just a significant part of it.

In some countries where the concept of tax grouping does not exist, a company that has only one economic owner is treated as a flow-through entity. It is disregarded as an entity separate from its owner for tax purposes, so that the assets, liabilities, and activities of the subsidiary are treated as the assets, liabilities, and activities of its owner. This is conceptually slightly different from a tax grouping of companies but it has in essence the same financial consequence: a parent and its subsidiary are treated as one entity for tax purposes.

This provision is crucial for an LBO as the HoldCo taken independently is intrinsically a loss-making company for tax purposes. Its profit and loss statement is made up of dividends (non-taxable or almost, as explained above) and interests due on the acquisition debt (deductible for tax purposes). Conversely, with the target being an operating company, it is logically profitable for tax purposes. The possibility of merging the results of the HoldCo and the target for tax purposes means that the profits of the target are partly offset by the losses of the HoldCo. In other words, the total amount of tax paid after the acquisition is lower than when the target is a standalone company.

1.2.2.3 Alternatively, a Merger or a Debt Push Down

The buyer of a target company cannot always benefit from an optimal tax structure. This is notably the case in countries where the deductibility of interest by acquisition vehicles is limited or simply not allowed. If these limitations are too stringent, two alternative structures can be implemented: (i) a merger between the HoldCo and the target company, or (ii) a debt push down. These solutions are usually not implemented immediately after the takeover. They generally take place a few years after the acquisition, as they may otherwise be perceived as too aggressive by the tax authorities of the country where the deal is located.

A merger between the two entities may be a solution but raises questions from a financial and legal perspective.

From a financial standpoint, the merger may be complex if there are significant minority shareholders in the target company alongside the HoldCo. Since the buyer controls the HoldCo with a limited amount of capital only, the buyer can be significantly diluted after a merger. It has a lower share of capital in the target company than the HoldCo used to have.

In some countries, the merger between an operating company and a company with a large amount of debt can be seen as going against the interest of the target. There is a legal tension between what an owner (i.e. the HoldCo) has a right to do and the interest of the target company taken independently (as a standalone business). The feasibility of a merger depends on which country the merger takes place in, but it is generally necessary to demonstrate to national authorities that the newly formed company can sustain its debt.

As an alternative to a merger, a shareholder can consider a *debt push down*, i.e. the transfer of the debt from the HoldCo to the target. A debt push down is usually done by having the target reduce its capital or pay an exceptional dividend to the HoldCo. This payment is financed by a new loan taken out by the target. This allows the HoldCo to repay its debt. An independent expert is usually invited to show the tax authorities that the business of the target is capable of repaying the new loan.

1.2.3 Managerial Leverage

What is key to any LBO is the operating performance of the target company. Whatever the acquisition package or the audacity of the tax structure, an LBO cannot be a success unless the target company generates sufficient cash flow to service the debt and pay dividends to the new owners. An LBO is therefore not just a financial structure: it is a business adventure. The management of the target company has to find the right recipe to improve sales and profitability despite the additional pressure created by the large amount of debt raised by the HoldCo.

1.2.3.1 LBOs by Investment Firms

As already explained, LBOs are often structured with the involvement of managers. These managers can be in place prior to the buyout (MBO) or join only when the company is acquired (MBI or BIMBO). Managers are in both cases instrumental to the success of the transaction. LBOs promote the concept of manager-shareholders who become directly interested financially in the success of the target company.

In most companies, managers are mere employees of the firm they work for. These managers can have large responsibilities and make a lot of money but they still have shareholders to report to. Their own interests are not necessarily the same as the company they manage. They may favor short-term gains or view their position only as a

means to a better job in a larger company. The situation is different in an LBO. The manager becomes a shareholder of the target company and is directly incentivized to focus on increasing its performance and valuation.

The management theory behind an LBO is that, all things being equal, the motivation of an entrepreneur – or at least a manager-shareholder – is higher than that of a traditional executive. Once a manager's personal wealth is directly indexed to the company's profits, he or she should work hard to increase the value of the target company. It is for this very reason that many LBO firms favor MBOs. They invite managers to invest alongside them to align shareholders' and managers' interests. Alternatively, LBO firms can also give the managers stocks or stock options.

The success of acquisitions by LBO firms is not only due to the incentive given to managers. LBO firms are experienced shareholders, they buy out a company with a strategy in mind. As majority owners, they have full latitude to implement their plans and choose the managers who will execute them. LBO firms can obviously make mistakes but they generally give a clear roadmap for the target company.

1.2.3.2 The Acquisition of an SME by an Individual Buyer

Managerial leverage takes a different form when the acquirer is an individual. In this case, the company changing hands is usually very small. It is sold by an entrepreneur who has put their money and their soul into the company. The acquirer does generally the same, meaning that both the buyer and the seller are financially and emotionally attached to the company.

That said, it could reasonably be assumed that a buyer who invests a large part of his savings in a new business is more committed to the success of his company than an owner who looks forward to selling his or her business and enjoying their retirement. A new manager, energized by a fresh start, brings new ideas, new methods and an attitude that can make a difference.

1.2.3.3 The Build-up

In a build-up the managerial effect is limited. In this scenario a company under an LBO acquires another company. Improved performance comes more from synergies between the two companies than from a change in management.

Examples of potential synergies include:

- increased investment and development capabilities
- sale of new products or services that could not have been developed before
- sharing of best practices between the two entities of the group
- reduced costs thanks to greater purchasing capabilities or strategies
- merger of the two companies' internal functions
- easier access to credit.

Case Study 1: The Harley-Davidson LBO (1981–1986)

The 1981 leveraged buyout of Harley-Davidson has all the ingredients of the perfect LBO. It almost looks like it had been done to be a case study for future MBA students. Structured at a time when leveraged buyouts were still a novelty, it combined all the features of a successful LBO: (i) audacious financial structuring, (ii) company turnaround, and (iii) entrepreneurial adventure.

The Birth of a Myth

The first Harley-Davidson was manufactured in Milwaukee in 1903 by Bill Harley and the brothers Arthur and Walter Davidson. Their prototype was imperfect (riders still had to pedal up slopes!) but this did not discourage the three friends. The trio achieved a reputation for being skilled mechanics and they soon started to sell motorcycles to friends, relatives, and neighbors. Their first factory was built in 1906 and the following year they were joined by William, the third of the Davidson brothers.

Walter Davidson – who was chosen as CEO of the company – convinced his three partners to focus on the production of powerful motorcycles. The objective was to win races to promote the brand and attract press coverage. The bet paid off. Harley-Davidson motorcycles performed well at these events and Walter Davidson won a few races himself. Company sales increased rapidly, and in 1908, Harley signed an agreement to supply the Detroit police department.

Four years later, Harley-Davidson was distributed by more than 200 retailers throughout the country. It had numerous contracts with local police forces and also secured major contracts with the US Army. The company sold 20,000 motorcycles to US forces in 1917 and supplied the army during World War II. The WTA model used by US soldiers during the liberation of France contributed significantly to the visibility of the brand in Europe.

Over the years Harley-Davidson slowly became an integral part of American culture. The brand became extremely popular. Its loyal customer base appreciated the sound of the engines, the rebellious image, and the distinctive design of the motorcycles. Actors like James Dean and Marlon Brando were faithful users and a movie like *Easy Rider* looks in retrospect like a TV commercial for Harley-Davidson.

In 1953, following the insolvency of its main competitor, Indian Motorcycle, Harley became the only motorcycle manufacturer in the US (compared to 110 when the company was founded). At that time, Harley-Davidson controlled more than 60% of the US motorbike market across all segments, small, medium, and high-powered.

The Problems

The 1960s were a period of intense change for Harley-Davidson. The company went public in 1965 with the double objective of raising capital for new investments and allowing the heirs of the founders to monetize their equity stake. Four years later, the entire company was acquired by AMF Group, a US conglomerate whose owner, Rodney Gott, was a die-hard Harley fan.

AMF Group unfortunately did not have a clear strategy for Harley. Despite heavy investments, the quality of the motorcycles started to deteriorate, hurting sales and damaging the brand. The drop in quality was all the more problematic as it coincided with the entrance of Japanese manufacturers into the US market. Harley-Davidson struggled to respond to the challenge. Japanese motorcycles simply had better designs and were more reliable.

When they entered the US market towards the end of the 1950s, Japanese brands like Honda, Yamaha, Suzuki, and Kawasaki were looked down upon by Harley-Davidson. Japanese manufacturers focused on small motorcycles and were not perceived as a threat by Harley's management. The brand had always specialized in high and medium-powered engines. Facing no competition in their segment, Japanese manufacturers started to swamp the market. Honda's turnover in the US rose from $500,000 in 1960 to $77 million in 1965.

From the 1970s, Japanese brands entered a second phase of development. They took advantage of customer loyalty acquired with their smaller machines to start competing directly in the medium and high-powered segments. Within a few years, Harley-Davidson lost its leadership in that category, first to Honda and then to Suzuki.

It seemed that nothing could reverse the decline of the brand. A joint venture with the Italian group Aermacchi to manufacture smaller motorcycles and the investment in new production lines were both blatant failures. The company became associated with low quality and production delays. A new marketing strategy, implemented to rejuvenate the image of Harley, only made things worse. In order to appeal to a larger pool of potential clients, the company moved away from its rebellious image and became more mainstream. This won few converts, while faithful customers were left bewildered. As difficulties multiplied, AMF Group hired Goldman Sachs to find a buyer for its subsidiary.

The LBO

Given the difficulties that Harley was facing, very few potential buyers were interested in the company. Many believed that its steady decline was unstoppable. After all, Harley-Davidson was an oddity. All the other US brands had long since disappeared. There was simply no room in this market for a company that manufactured motorcycles in the United States. No one could compete with Japanese products . . . Despite Goldman Sachs's intense marketing efforts, AMF did not receive a single offer for Harley.

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In this context, the idea of an LBO begins to percolate. In 1981, the 13 top managers of Harley-Davidson, headed by CEO Vaughn Beals, decided to buy out the company themselves. After several months of difficult negotiations, Harley-Davidson was finally sold through an MBO to this group of managers. The company was valued at $81.5 million and 87% of this amount (a very aggressive ratio) was financed by a debt facility provided by Citibank.

CEO Vaughn Beals was an MIT graduate with previous experience in the aeronautics industry. He joined the group in 1977, but was never given the freedom to carry out his vision for Harley-Davidson by AMF. Vaughn Beals was nonetheless convinced that he could restructure the company and put it back on track. To celebrate the acquisition, he organized a motorcycle trip between New York and Milwaukee for the group's new shareholders. The impact on staff and retailers' morale was immediate. Some employees even took their bikes to join the new owners.

The Management, Post-LBO

Beals' first decision was to set a tour of a Honda factory for Harley's managers, engineers, and union representatives. They were all astonished by the cleanliness of the site. They also realized that production was less modern but better organized. The operating mode emphasized the *just in time* method. Motorcycles were produced only when ordered, which meant that stocks were limited and that new improvements could be added to existing models without delay.

The group of visitors was also very surprised to see that the morale of the employees was better and relations were less strained than in their own company. One detail stood out: the engineers knew all the workers by their first names. The Honda factory seemed superior in every aspect. Not only was the atmosphere much better than at Harley's but production figures were outstanding. Only 5% of the Japanese motorcycles did not pass the quality check at the end of the production line against 50% for Harley-Davidson.

Given the precarious situation, Vaughn Beals decided to act swiftly and introduced a series of radical changes to turn the company around. The Japanese methods observed at Honda were adopted and 50% of the workforce was laid off to adapt the cost base to the decline in production. Unions gave up a salary increase planned before the acquisition and remaining employees accepted a 9% pay cut.

In terms of the product itself, a new and more reliable engine was conceived by Harley-Davidson's engineers. It passed quality checks more easily, which allowed the company to achieve considerable savings. In parallel, the design of the motorcycles was entirely revamped. The objective was to differentiate Harley-Davidson from the competition. Chrome parts were made more visible and the mass marketing strategy was abandoned. The company reconnected with its roots and rebellious identity. Everywhere in the United States showrooms were refurbished to highlight the return to Harley's original positioning.

Back to the Stock Market

Thanks to these tough decisions and the adoption of Japanese methods, Harley-Davidson quickly regained market share. Turnover increased by 130% within five years and in 1985 the company was the new market leader ahead of Honda in the high-powered motorcycles segment. Brand image improved significantly, and Harley-Davidson became known once again for the quality and reliability of its products.

Despite these successes, Citibank decided unexpectedly in 1984 not to renew the facilities granted to finance the LBO. The bank feared that the cumulative effect of an ageing population and a lukewarm macroeconomic outlook might threaten Harley's recent recovery. Vaughn Beals found a new lender ready to replace the bank at the last minute: Heller Inc., a lending institution specialized in medium-sized companies.

Vaughn Beals and the other shareholders were deeply affected by Citibank's decision. They realized that the success of an LBO is fragile and depends largely on the availability of funds to secure a transaction. They decided, therefore, to monetize part of the value they had created and accelerate the return of Harley-Davidson to the public market. The initial public offering (IPO) was arranged in two steps. A first stake was introduced in June 1986 and a second in June 1987, on both occasions with a much higher valuation than that of its competitors.