

FIN 423 Going Private

Leveraged Buyouts (LBO's)

Management Buyouts (MBO's)

Junk Bonds

Alternative Organizational Structures

MBO's vs. Interfirm Offers

Incentive (Agency) Problem:

- **target management has little incentive to get a high price for its (outside) shareholders, because it comes out of their pockets!**
- **solved by having a committee of outside directors run an auction by seeking alternative bidders**
 - **hire separate lawyers and investment bankers**

MBO's vs. Interfirm Offers

RJR Nabisco:

- **Ross Johnson, CEO, made MBO offer**
 - **lost to KKR group in auction**
 - **Barbarians at the Gate**
- **similar situation when Sybron went private**
 - **committee headed by Bob Sproull sold Sybron to Forstmann Little instead of inside management team**

Leverage and Going Private Transactions

Jensen argues that highly leveraged LBO's are conducive to efficient management because it forces hard decisions

- **eliminate waste and inefficiency**
- **capital budgeting decisions are made on NPV>0 basis, rather than spending 'free cash flow'**

Junk Bonds

Junk bond market allowed firms to sell complicated series of instruments

- **senior debt**
- **junior/subordinated debt**
- **convertible debt**
- **warrants**
- **equity**

get benefits of interest tax deductions, and retain ultimate residual claims in hands of decision-makers (management & LBO general partners)

Junk Bonds

Junk bond contracts were designed to minimize expected bankruptcy costs

- **underwriter (DBL) would organize buyers as a cohesive group by selling portfolios of bonds from different companies**
 - **if trouble occurred, they could act to reduce the conflicts among creditors**
- **many private reorganizations have occurred without the use of formal bankruptcy proceedings**

Evidence on LBO's: Offer Premiums

Premiums are as high, or higher, than in interfirm tender offers

- **50% plus in DeAngelos' study**
- **usually occur where management already has a large ownership stake**
- **no evidence that (outside) stockholders are being systematically exploited**

Muscarella & Vetsuypens(JFin,1990): Efficiency Gains in LBO's

Study reverse LBO's

- **firms coming public after going private earlier**
- **72 cases from 1983-87**
 - **54 are divisional LBO's**
- **only 5% of the LBO's from 1981-86**
- **after IPO management & directors have large stockholdings (45%) and there is little turnover**

Muscarella & Vetsuypens(JFin,1990): Efficiency Gains in LBO's

Many have asset sales or reorganizations

- also, changes in pricing policy, quality, labor force
- often reduction in middle management

Table 5:

- accounting performance while private is much better than for typical public firms (from COMPUSTAT)
 - operating margin
 - production costs

Muscarella & Vetsuypens(JFin,1990): Efficiency Gains in LBO's

- median annualized return on LBO equity is 268%
- mean annualized return on LBO equity is 1999%
- comparable 93% leveraged S&P return has a mean of 675% (median 196%)
- a lot of the high returns come from high risk and illiquidity
 - also, these are the deals that paid off fast

**Baker & Wruck (JFE, 1989):
O. M. Scott LBO**

- divisional LBO form ITT in 1986
- Scott's fertilizer (market leader)
- Clayton & Dubilier were general partners
- detailed analysis of financial structure
 - covenants and seniority of debt
 - ownership structure of equity
 - incentive compensation/bonus plans
 - capital budgeting procedures
 - working capital management

**Baker & Wruck (JFE, 1989):
O. M. Scott LBO**

- dealings with downstream distributors became more aggressive
- pricing policies became more aggressive
- employment was not cut dramatically

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