FIN 540
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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