Ned Krastev

Leveraged Buyouts

Course Notes

365

Leveraged Buyouts

An introduction to LBO deals

A leveraged buyout (LBO) is a transaction in which a Special Purpose Vehicle (SPV) primarily funded through debt financing acquires a target company characterized by low debt levels and consistent cash flows.

What is an LBO?

Leveraged buyouts are deals in which the acquirer of a firm uses a high portion of debt to finance the deal. The collateral for the debt is the target's cash flows. Lenders are willing to provide their funds because the target has a solid underlying business that is expected to generate a stable stream of cash flows, so they are likely to be repaid in full.

When is it feasible?

Mature companies are the ideal target for LBO transactions. They are well-established in the market and typically generate a solid stream of cash flows. There is little room for innovation in their line of business, so their cash needs are limited and predictable. It is reasonable to expect that acquirers will use the cash flows from the company to reimburse the high leverage generated in an LBO transaction.

Leveraged Buyouts

An introduction to LBO deals

70 – 75% of the deal is financed through debt and mezzanine loans. Financial sponsors can acquire large companies with minimal investment by applying significant leverage.

The amount of debt in an LBO

Financial sponsors are willing to take on board as much debt as possible. However, lenders need to know that there is enough equity to protect their capital and decrease the overall risk of the transaction. For every firm, we can measure the so-called maximum debt capacity, which is a function of the firm's cash flows and risk profile.

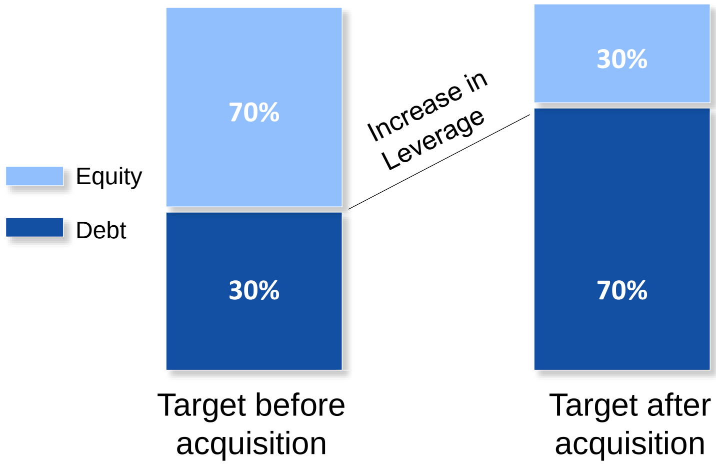
The lenders in an LBO

LBOs are a risky business, and lenders expect a good IRR. Senior lenders' remuneration will come from the spread on money market rates. They will consider the initial debt drawdown amount, the holding period of the deal, the periodic interest rates to be received, and the principal repayment at closing. Mezzanine investors have different risk profiles. They make an initial contribution and receive periodic interest rates, a principal repayment at the closing of the deal, and an equity kicker. The equity kicker allows mezzanine investors to acquire shares of the target company at a predetermined price upon exit, which ensures they participate in the upside of the deal.

The Mechanics of an LBO Transaction

How does an LBO work, and how do financial sponsors make money?

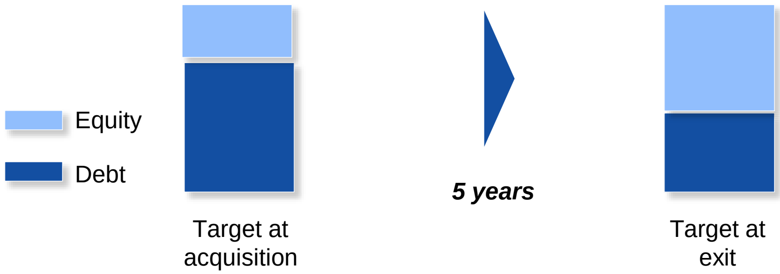
How does an LBO work?



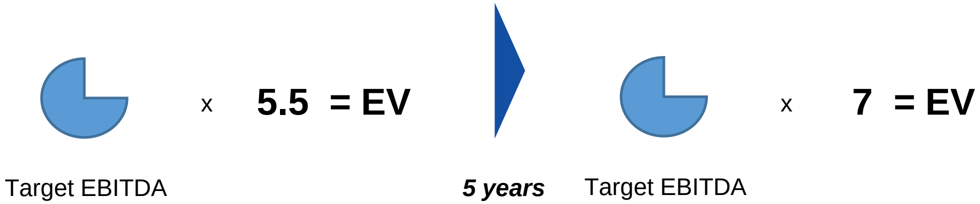
Leveraged buyouts are deals in which the acquirer of a firm uses a high portion of debt to finance the deal.

How do financial sponsors make money in an LBO?

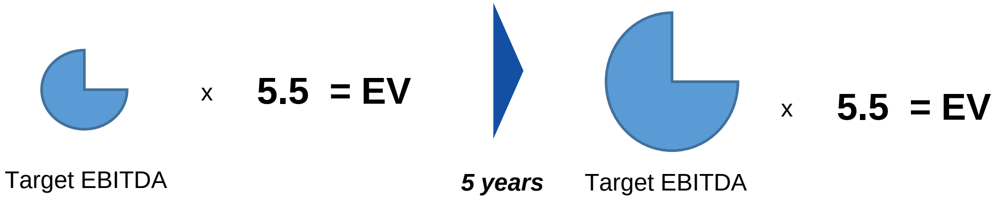
1 Repaying debt (Deleverage strategy)



2 Selling for a higher multiple (Arbitrage strategy)



3 Growing profitability (Growth strategy)



Finalizing the Deal

Completing an LBO deal in practice

Phase 1 — **Newco BS**

Cash 100%	Debt 30%
	Equity 70%

Phase 1: Financial sponsors create a new company that has the cash necessary to complete the deal

Phase 2 — **Newco BS**

Target Shares 100%	Debt 30%
	Equity 70%

Phase 2: The Newco acquires the Target's shares

Phase 3 — **Merger**

Target's Assets 100%	Debt 30%
	Equity 70%

Phase 3: The Newco and the Target are merged

Ned Krastev

Email: team@365financialanalyst.com