**Mergers, Acquisitions and Corporate Restructuring**
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**Lecture - 39**
**Leveraged Buyouts**

Hello friends, welcome to another session on mergers acquisition and corporate restructuring in this unit that is the last unit of the course we are discussing about alternate exit strategies by different companies when they like to split the company or they have to break into multiple parts. So, we discussed about like equity curve outs split off, spin off all those things in the previous sessions.

In this particular session, we will talk about another very important aspect in mergers acquisition and that is happening around the world is called leveraged buyouts. These leveraged buyouts are very popular now. Several companies are being acquired with the route of leveraged buyouts. We have discussed about leveraged buyouts in the initial weeks, but we in this particular session will talk in detail about the leveraged buyouts and how it is executed by different companies.

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We have these consider leveraged buyouts we will also talk about what can make a particular leveraged buyout successful we also talk about management buyouts and discuss what financing of buyouts.

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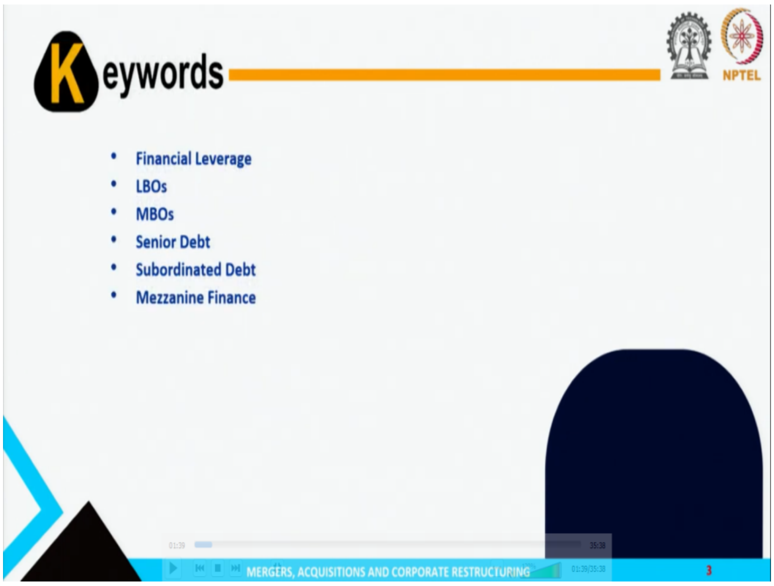


These are the keywords we talked about financial leverage a concept LBOs MBOs and different types of debt, different types of finance available for the purpose of leveraged buyouts. Before you go to the leveraged buyout a deal structure or deal or as a financing option, we will let us try to understand what is meant by leverage that is called the financial leverage assets leverage is something where with the help of something you are able to get more result in a simple physics or mechanic comes in you can say same force but more result.

Because use of certain instruments techniques, like you have a gear lever fulcrum so, with that what do we do we are able to get more result because although is the same forces.

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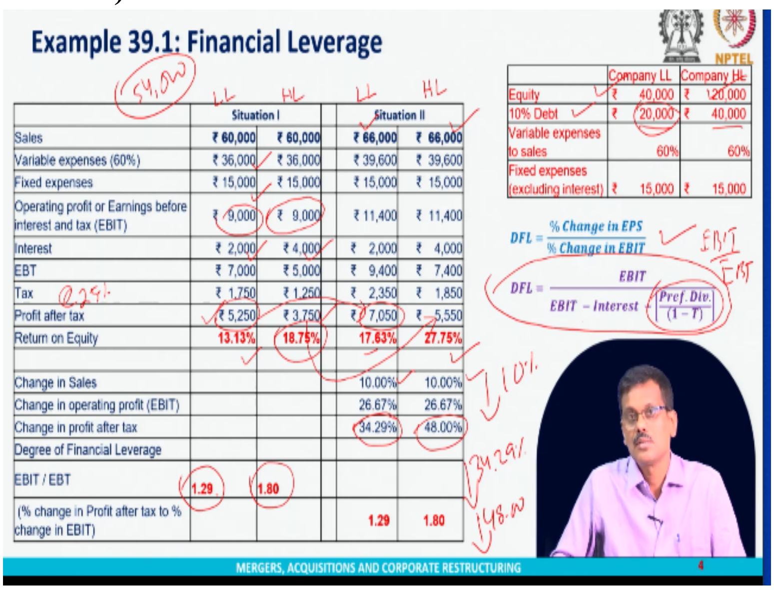


So, we will take an example of financial leverage here, we have 2 companies that is called company LL let us say low levered company HL that is let us say it is high levered. So company LL means they have less loan both the companies have same amount of finance

60000 rupees total finance or capital company LL has equity 40 whereas HL has 20000 and debt is lower in case of company LL.

So, you have got 20000 debt whereas 40000 debt is their company HL and these companies have a operating cost structure, where the variable expenses sales comes to 60 percent of the sales and the fixed expenses excluding interest because interest is a fixed cost. So, fixed expenses and operating fixed cost is 50000 each. So, both the companies operation while operating wise both the companies are same, but finances structure is different.

So, in that case we have a situation 1 this company is LL and this companies HL similar situation to this company LL and this companies HL. So, we have 60000 rupees sales on that 60 percent goes to variable cost, fixed expenses 15000. So, that way we have got 9000 was operating profit or profit before interest and tax earnings before interest and taxes EBIT both the cases 9000 the earnings before interest in tax.

Whereas in these companies in 10 percent debt is there so, 10 percent 20000 comes to 2000 interest, this company the interest is 4000. So, earnings before tax 7000 5000 taxes is taken at 25 percent to that way, tax is lower in case second company, even profit after tax also lower in case of second company that is HL higher in first company but if you want to find out the return on equity which is nothing but profit after tax divided by equity, that comes to 13.13 percent whereas it is 18.75 percent as a percentage of 20000.

So, that shows that a highly levered company is able to have more return on equity although the cost structure is same for both the companies it is having a higher return on equity compared to the low levered company. So, that is the impact of financial leverage on the return on equity. But, one thing 1 must alert here is that suppose the situation is different instead of 60000 rupees sales in sales was much lower in that case possible that high levered company will have lower return on equity.

Because interest has to be anyway paid by the company will interest as a compulsory expense. So, similar then what happens another impact how finance leverages their second debt impact. Suppose the sales of the company both the companies increase by 10 percent. So, sales becomes now sequential situation 2 66000 66000 so, variable expenses fixed expense remained the same. So, we can see that the EBIT is now 11400 come to 9000 for both the companies interest has remained the same situation 1 situation 2.

But interest will not vary because the revenue is increasing interest will not change for that matter interest the fixed costs are fixed financial cost. So, that what has happened now, you have what 7050 is profit after tax from 5250 it becomes 7050 similar 3750 became 5550 in HL. So, now, return on equity 17.63 and 27.75 as usual high levered company has more return an equity.

But one thing if you want to observed percentage change in sales is 10 percent and percentage change in earnings operating profit is 26.6 percent. Why is the percentage change in operating properties higher than percentage change sales because the company has fixed cost in operating costs? Since fixed costs is not changing, only variable costs is changing. So, there is a growth in profit is higher than growth in sales that is called the impact of operating leverage.

But our focus is on finance leverage so, profit after tax is now 34.29 percent more in situation 2 competitive situation 1 as far as the low levered company is concerned, but profit after tax has gone up by 48 percent in case of highly levered company. So not only that financial leverage gives more than an equity, but there is a change in operating performance sales etc. That impact on the profit is going to be higher in case of high levered company which service low levered 1 company.

And 1 must say 1 must emphasize you have that support the situation or the other way around, instead of 10 percent increase in sales, it has a 10 percent fall in sales suppose the sales who have been 54000. If 1 can recalculate the figures and this particular thing recalculate 1 will also find that there is a fall in sales of 10 percent there will be also fall in net profit by 34.29 percent in case of company, it LL. Similarly, the fall in profit will be 48 percent with respect to fall in sales by 10 percent high levered.

So, leverage says that the change in profit to change in sale, so, the change is favorable change also resulting from favorable change unfavorable resulting from unfavorable. So, high levered means, more change low levered means lower sales or slower sales in that case high levered company is more risky, low levered company is highly risky and in a simple format all the different formula that is called degree of financial leverage.

Which is nothing but percentage change in EBIT to percentage change to EBIT or are the particular labelers 1 can find out the DFL is this formula EBIT by EBIT - interest - preferred dividend by 1 - T of course in this exercise we do not have preferred dividend. So it becomes now EBIT by EBT – interest. So, effectively it is EBIT by EBT here. So, that will apply in that 1.2 and 1.80 or 1.2 and 1.8 that indicates. If there is a change in 1 percent in the EBIT there will be 1.29 percent in profit after tax return or unexpected share for that matter which is 1.80 in case of high levered company.

So, that we say that financial leverage has an impact on return on equity more the leverage is more than an equity but the loss making company more leverage more loss will be taking place. So, honestly very careful going through leveraging itself and the company. So, how much capital is taking a loan, how much equity have? So very careful about that, but at the same time, leverage has had an impact leverage benefits and the conditions to good leverage can hard when the condition is bad.

So at the same thing, several companies are now going for acquiring different businesses with the help of lot of loan. So if they are using loan as a financing an acquisition, so that can be taken as a leveraged acquisition or leveraged buyout where they are buying out the companies a leveraged buyout.

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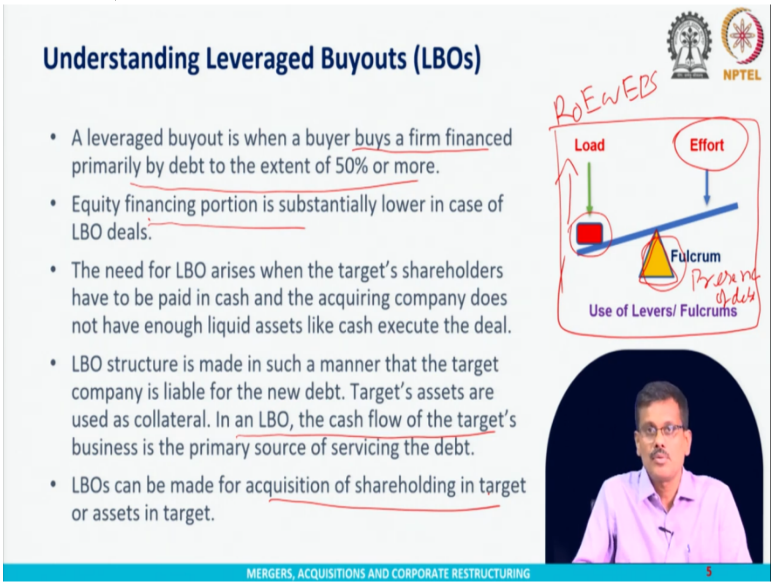


So leveraged buyout we can say when a buyer buys a firm financed primarily to buy debt at least to the extent of 50 percent or more. So, this is an example in a general PGXR mechanic term. So you have got a effort because it is fulcrum available here lever available here. So load can be lifted more easily. So in the finance we can say this is the presence of fixed costs, in this case finance levels, you can do it we take an example of presence of debt.

So presence of debt these the effort as the company has many more sales, profit, etc. And this could be the load taken that could be the impact on return on equity or earnings per share, like that. So and LBO what are the different levers LBO characteristics or features? Equity financing is very low, substantially low in LBO and the need for LBO may arise when the target seller just wants the gas and the acquiring company does not have that much gas with itself the liquid assets.

So they will take the loan and pay the cash at the same time LBO structure is made in such a manner the target company is only liable for the new debt that means the loan is taken against the assets of the target company and the acquiring company the priory company major group company which is interest acquire a company they are balanced and insulated from this impact of leverage on the target companies balance sheet.

So in an LBO, what will happen when the lender is giving a loan, they are looking at the cash flow of the targets business against that they are giving the loan that is what is going to happen with that is going to be primary source for servicing the debt subject to some guarantees given parent come in another matter but when the lender is giving a loan, they are looking at the cash flow the targets business. And LBOs also can be made for acquiring the shareholding in a company or also can be also buying the assets of the target also instead of going for acquiring company and can also acquiree the assets.

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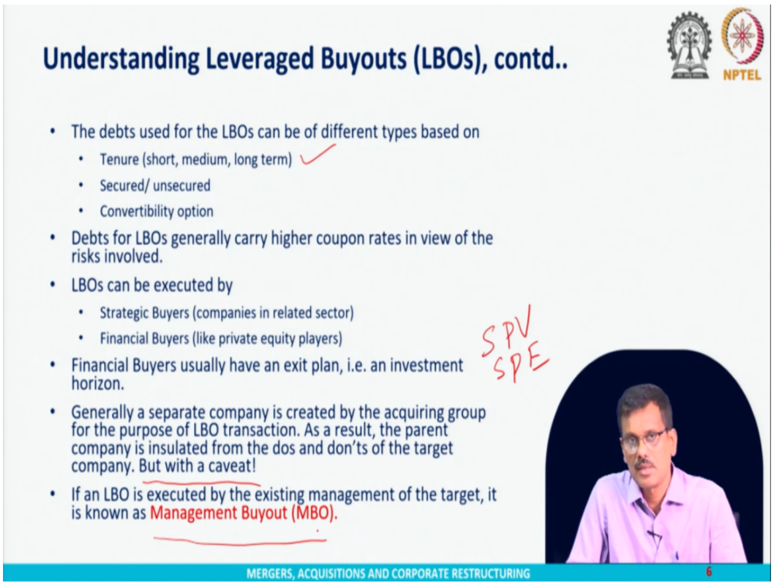


And different debts that can use in case of an LBO could be in terms of tenure, it could be short term, medium term or long term. It can be secured or unsecured also and it also can be convertible non-convertible debt also can be used as a part of debt financing in case a leverage buyouts and debts for leveraged buyouts generally carry higher coupon rate means interest rate because of the risk involved, because high risk more the debt more risk involved.

So, that way they will be having more interest or coupon rate on the loan assets and as the secured condition of the loan is getting lower that means interest is going to be higher. So, unsecured loan will have a more interest rate compared to a secured loan for that matter. LBOs can be executed by strategic buyers that means, 1 company will like to buy another company similar sector related sector.

They can also take a loan and buy another company, another financial buyers actually financial investors, the will invest in a company with the help of debt or they may find the debt they may find equity or they found equity and they get debt whatever they may be. So, financial buyers there but financial wise like private equity players out there so, they can also be doing LBOs and is financial buyers what they do when they invest in through an LBO for that matter.

They will have an exit option they will always think about that as we will be investing in this particular company with whatever financing mode and but there will be a time period by which we will exit from this particular investment and take the investment some other company for that matter they have an investment horizon or a strategic buyers name in and may not have as long as this company is suitable good for them is add value to the company they will continue in their particular business.

Generally, what happens a separate companies created by the acquiring group for the purpose leverage transaction so, that can be told as a special purpose vehicle or special purpose enterprise a special purpose enterprise created which will actually acquire the business or the assets liability or equity for that matter of the target company. So, what happens that way separate because you are separate companies floated separate company will take the loan.

So, the parent company is insulted from the suppose there is any installment basis reason of the separate purpose enterprise if suppose final a deal does not become successful that deal is not going to give good benefit, although to acquire but it does not serve the purpose. So, there is possibility that the debt will be now cannot be paid, that we problem in that case, the parent companies balance sheet is not affected by that.

Because the loan is not taken in the balance sheet of the parent company loan is rather taken in the balance sheet of another special purpose enterprise which is only one owned subsidiary the parent company, so, that we insulate, but at the same time 1 has to be careful that because group company is defaulting. Obviously, overall group company is going to be affected by their crediting you into affected by that although technically they are not going to pay for the dos and do nots of the subsidiary company.

But technically they cannot be insulated fully that some group company has defaulted on the parent company can be exonerated from that for that matter. And if this LBO structure whatever you discuss is executed by the existing management of the company suppose there is a owner in the company owner is there an owner will like to exit because of whatever result was chosen as a private limited company and closely held and those owners investors will like to exit and they do not continue.

So the income and management, the operating management; who are managing business, because they know that business doing well. So, they may take some stake and rest of the stake that the company that can be financed by the loan and the income and owners can exit and this is the structure that means present management is executed in the LBO that is called a management buyout. So, that means all LBOs are by default, LBOs because they management takes a loan and with that, they acquired the company for that matter.

One of the example, could be that the capital first was formed as a concept of management by owned Mr. Vaidyanathan then and it was from a NBFC of futures group at that point of time, which was actually converted in to a another company called capital first, by the help of management buyout. So, they took the Mr. Vaidyanathan took the help was a private equity players and they also took the stake in the company. And now they manage and subsequently capital first is most with IDFC bank presently. So, now it is IDFC capital first IDFC first is there now as a bank for that matter.

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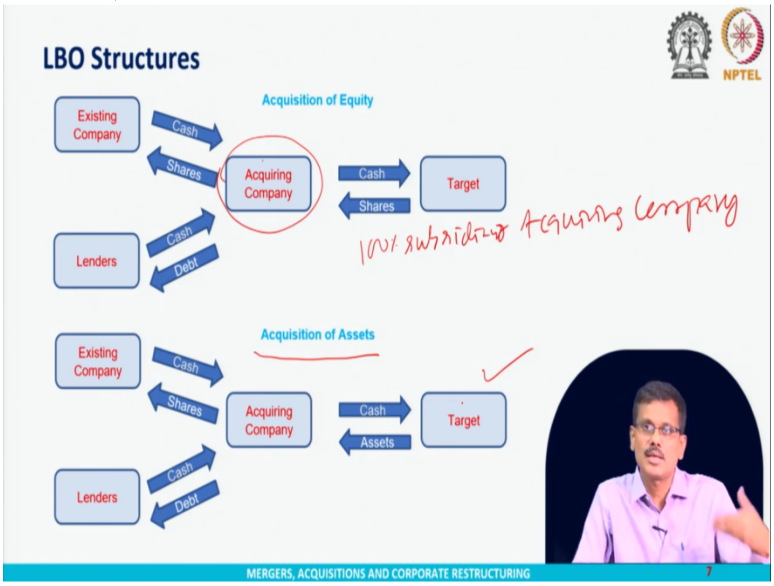


So, these are LBOs structures could be there as you discuss it could be equity acquisition or it could be an asset acquisition. So, you can see here is existing companies is there are a parent company you can say they float an acquiring company, they give cash to acquiring company and take equity in that could be mostly 100 percent and lenders will also cash give the cash to the acquiring company and they take they issue debt to the lenders.

And acquiring company gives the cash and take the shares of target. So, target becomes let us say 100 percent subsidiary of acquiring company. So, target is slowly target can be written as subsidiary or later target may be mashed with acquiring company and only acquiring company may remain and acquiring company is a subsidiary of existing companies. Similarly in case acquisition of assets same thing as your financing is done.

Whereas acquiring company give cash with target and target will transfer the assets to the acquiring company. So, target company remains there shareholders will remain they will take the cash what they will do to that comment that is up to them, but acquiring companies having the assets of the company. So, now it is will 2 companies existing 1 is called existing company and acquiring company target company has nothing to do with the existing company for that matter.

There are several other deals structures can be there and 1 can say here suppose in Indian companies like to acquire some of business in another country assets foreign acquisition is a directly taking stake in the foreign company what the target company they would like to float a special purpose company in that country or maybe another country which has got is more friendly in terms of regulation compliance and other country for that matter.

They flow tech company there and that company will acquire the target. So, this is also called another example of special purpose enterprises creators will see 2 examples regarding the how an Indian company have executed this particular structure assets.

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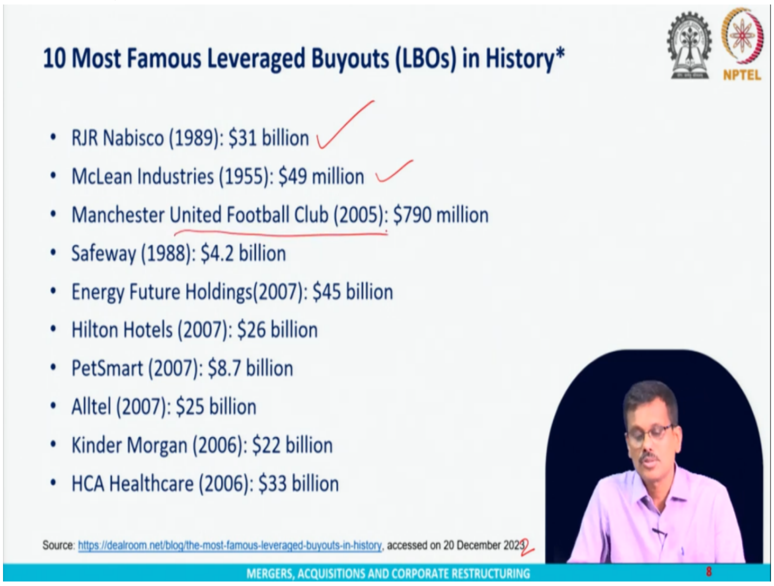


So, these are in the look at recent history, we have different famous deals assets. So, in the literature say that the earliest LBO could be this Mclean industries with a 49 million small size that tattoo looks like that but that was a big amount. So 1955 this is documented as a first LBO in the world, but only very 1 of the famous LBO is RJR Nabisco 31 billion deal. In fact, there is a movie also related to this particular LBO deal or this acquisition for that matter, that is sometimes called as a hostile acquisition.

So these are certain famous LBO deals that the world has seen including some football club also which is acquired with the leverage transaction for that matter.

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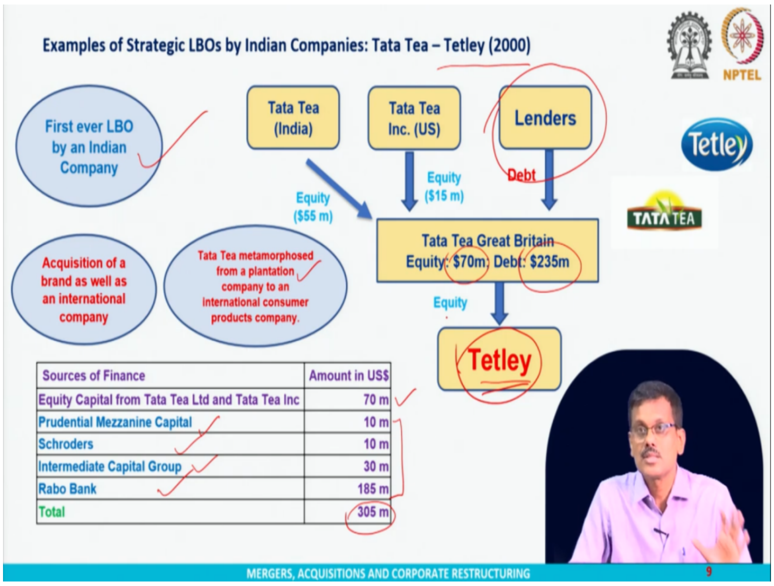


| Sources of Finance | Amount in US$ |
|---|---|
| Equity Capital from Tata Tea Ltd and Tata Tea Inc | 70 m |
| Prudential Mezzanine Capital | 10 m |
| Schroders | 10 m |
| Intermediate Capital Group | 30 m |
| Rabo Bank | 185 m |
| Total | 305 m |

And coming to another example of in Indian case in India, we can say Tata Tea acquisition of Tetley, your tea brand in UK or Britain for that matter in 2000 is the taken as the first ever LBO by an Indian company as at least formally documented although there could be so many acquisitions with the help of debt. But still, this is considered as the first ever LBO by an Indian company so what they did here how they structure so anyway one thing is that with this particular acquisition.

Tata tea acquired a very good prominent brand, internationally known Tetley. As well as they progress in an international company and Tata tea although they had you are selling the package tea but it is more of a plantation business. So, they the Tata tea got metamorphosed from a plantation company to an international consumer products company it is not only several varieties of teas brands that Tata Tetley heard of the Tata good get it and they could market it India and elsewhere in the world also.

So, this transaction was total 305 million US dollar including the amount they paid for the Tetley shareholders + any related some legal fees, etc. So, total are 305 million dollar and this is the breakup 70 million was through equity and rest of the balance amount was through debt, we have discussed this case also in some other manner in some previous in the other session also we are recapitulating them.

So, if you look at the structure, what the company did, Tata tea floated a company called Tata Tea Great Britain at that point of time and that was financed with 70 million equity by giving the Tata tea India as a Tata tea in incorporates they have already company. So these 2 companies gave equity support to Tata tea Great Britain 70 million and Tata great tea Great Britain took a low debt of 235 million from the lender.

These lenders are the students sales Schroders, intermediate and the Rabo bank. So, these lenders gives the loan to Tata tea Great Britain to fund the acquisition here called Tetley and in fact, they gave a loan on the support implied support of the cash is going to come the reputation of the Tetley for that matter when Tetley here. So Tetley business was the support for the loan given by lenders to Tata tea Great Britain so that is the way it has happened.

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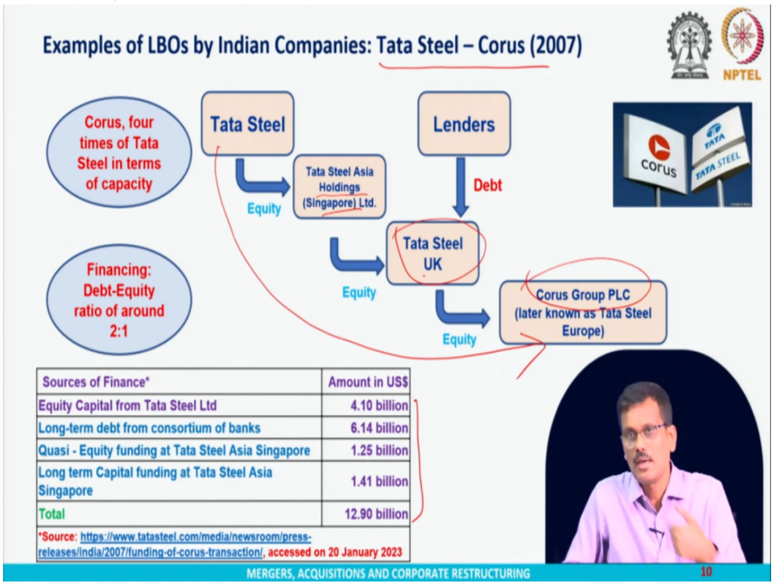


And another deal is even in Tata group so Tata Steel acquired Corus in 2007 a big fight took place with another company is also competing per acquiring the Corus. So, Tata Steel play with good premium on the existing market price of the Corus that time. Corus was 4 times Tata steel terms of capacity like in Tetley Tata tea, Tetley is much bigger than Tata tea but with the help of LBO a small company could acquire a big company and the debt equity is around 2 is to 1 and this is the stock financing source of the financing this Corus deal.

So, what if what happened here, Tata Steel actually had a stake in Tata Steel Asia holding Singapore and that company has a stake in Tata Steel UK and Tata Steel UK now occur this year of the Corus group which was subsequent on Tata Steel, Europe and then Tata Steel then it has been again some restructuring some names and has taken place but you are talking about that as of 2007 what happened. So, this is the way this took place so, instead of Tata Steel directly taking care in Corus, they went through this particular special purpose enterprises.

Because from the legal point of view from the International transaction point view it may be easy to have a company separate company acquiring the target instead of directly acquiring from the India assets.

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So, next is that companies do go for LBOs but what can make us successful LBO and would can help create more value for that matter as usual for any emergency acquisition transaction, selection of target is the ultimate thing it is the most important thing. So in that case for target selection, 1 has to see the how attract to the industry in segment? They usually look at LBOs you will find out more stable and nature industries not in that the operating in the little lower for that matter and they have lot of growth opportunities.

So that will invest that company will invest and they will get they will in cash on the growth and maybe later they may exit and the LBO deals also will involve the companies where existing management good management team is there. We do not expect the particular index of financial where you do not expect them to get the management to manage the business. So, they are visibly competent and motivated by management.

The company should have good operating margin operating like operating over the EBIT to the sales for that matter, if not at least there should be potential for improvement in operating margin. It also there could be poorly performing company but they have potential to improve that is also possible or there could be another type of LBO where a big company is there multiple divisions are there.

There could be some underperforming divisions, but they are made separate maybe they will do better and so those underperforming company can bring a better performing companies, and those can be converted as a separate company and divisions can be convert a separate company and against that can be acquired through in a leveraged buyout deal for that matter and also the company that we are at target must have good balance sheet.

Strong balance sheet means mostly because they are going to take a lot of loan they should have a lot of collateral assets collateral should be there. So that like they have a lot of land have assets, which can be used as a mortgage for that also they should be generating good cash flow profit, so that future cash flow is going to be there which can be used to service the debt and existing lenders do not have any covenants may restrictions.

Sometimes as you discussed in a takeover asset and defend some company may have a defense mechanism is called poison put. So, poison put is something where when the change in control takes place the lender will have the right to take back the money. So those who not be there, if that is there, then this cannot be there cannot be an LBO asset because lenders will ask for the money and you have to pay them also. So that has all the other we have to renegotiate lender the lender can continue the targets business.

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Then 1 has to avoid overpayment so that because sometimes what happens as a matter of who breeze companies promised to pay very high amount and that leads to over borrowing which cannot be serviced with the cash flow that is going to come to the targets assets. Debt is a double-edged sword we saw in the little fantasy leveraging example, that when the performance is improving.

There is a improving the recorded equity much better than what the sales growth in sale whereas if there is otherwise the other thing can also be there where there is a decline the performance, less operating performance, there it can harm. So the return is going to fall as always and it also become negative for that matter and the companies the management that is taking over the company the LBO they should look for continuous improvement partners of course that is a normal thing for any business or organization.

But they have to do that because they have taken a lot of loan and they have to service the debt and slowly and slowly they have to retire the debt also and it may call for some harsh decisions registering removing employees closing some businesses. So in their case what happens is financial buyers will be able to do it better than strategy buyer but to strategic buyers will not like to close down operations remove the employees they will not they will be a little hesitant.

So it was financial buyers may become ruthless for that matter and also how to make ensures private because once you make it private what happens the public company has a lot of issue compliance the compliance requirements are there are guidelines to follow. So, there is a lot of costs is there. So, that is called agency problem, because management console the agent of the public shareholders. So, all those things interests can be there. So, obviously LBOs are mostly private deals means the companies are converted to privately held companies.

If there is no management existing then in that case professional management can be introduced and discipline in management of the entity so that ensure timely the servicing of debt that is called interest payment and the principal repayment.

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Then another thing that helps your company is that tax shield because the company has taken a debt companies paying interest, interest can be taken as tax it will expense, tax deductible expense and that way tax shield there. So, they will structure in a deal such a manner that they get the tax shield in the initial years so that later what happens if you return then they reduce the debt. So gradually they reduce the debt and then as a financial buyer is there they like to timely exit or they may invite potential investors for participating in this company.

And the target can continue on the existing investor may exit, because exit has an option to be there for financial by a strategic buyers may not exit they may rather go for some other expansion options also.

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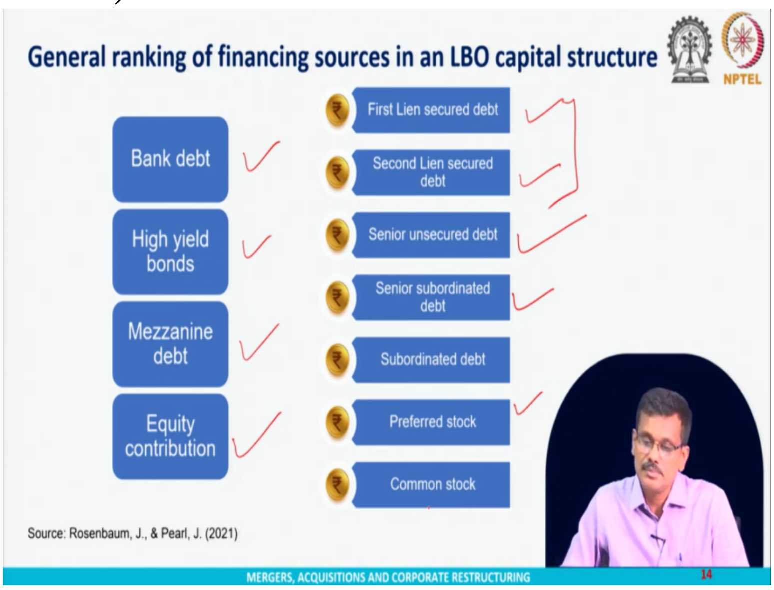


Coming to the how this leverage viable of finance, 1 is that we have bank debt is available, then we have subsequently high yield bonds, then your mezzanine debt mezzanine debt says sought file is there, so breeze loan amount, so, between high yield bonds and equity there will be something required. So a mezzanine debt can be taken then comes equity contribution, equity the last resort of finance.

And this debt that we have talking about that can be different types of debts can be there 1 suggested structure is first lien secured debt, second lien that means these are 2 are secured debt, but in that secure debt there can be class A and class B. So, class A people get the money suppose there is a problem, there is insolvency is there in that case what happened the secured assets will be disposed of cash will come back come to the company.

And so the first lien secured debt lender will be get the money first then come secondly lien secured then it goes to unsecured debt holders, then there is subordinated debt dominating their subordinate to the previous debt lenders. Then in that subordinated it also can senior at the junior different classes then the money can be given to the preferred stock then common stock in the when the companies dispose.

Similarly, that means this can also be taken as different financing options secured debt first lien secured debt and second lien secured debt in that also senior and junior subordinated debt which is junior to unsecured debt, preferred stock and preference shares preferred stock can be sorted then common stock or equity also can be issued to financier LBO like this LBO capital structure can be designed like this.

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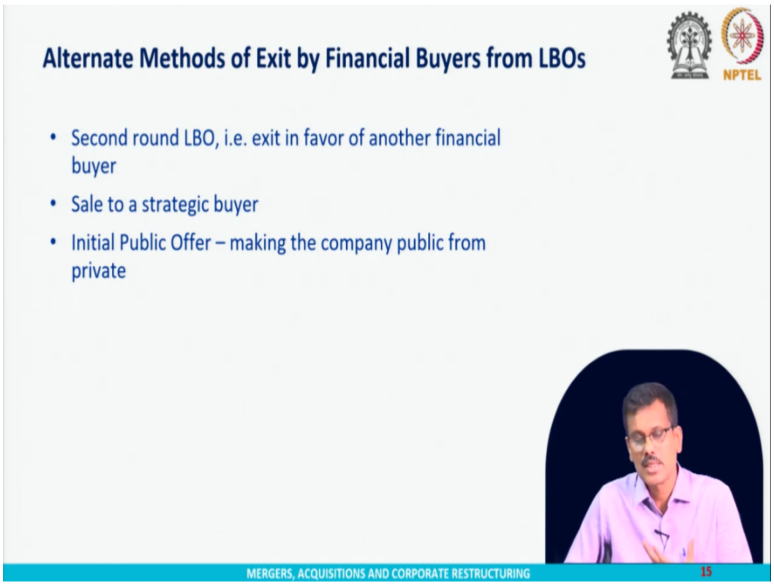

Then as any other buyout financial buyer may like to exit so, they can either go per second round LBO. So they will go for another LBO where they may exit or the company can come or they can sale the company strategic buyer they reap the benefits the best got the best of the return possibly and once the cream is taken that means the company has come to a stable stage of growth at the time they may sell to a strategic buyer or even company still has a growth.

They can get good value and they can sale to a strategic buyer or they can also go for initial public offering with the initial public offer. They can also upwards their shareholding and exit from the business and the company is now converted into a public limited from a private limited company. So, we have structures like public becoming private, private limited becoming public depending on the situation and the opportunity that is favorable to the stakeholders for that matter.

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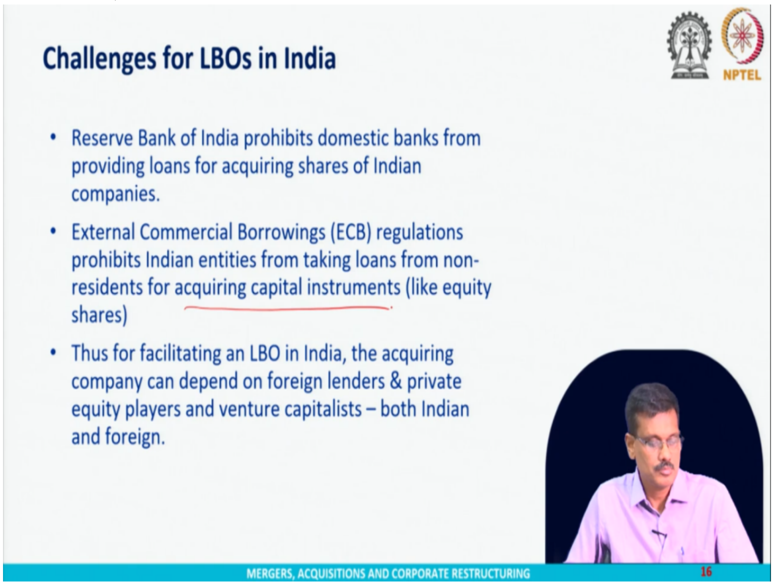


So, before you go to conclusion, look at the LBOs in India, there are certain restrictions like in Reserve Bank of India previous domestic banks from providing loans for acquiring shares some Indian companies. So, that option is not there that option is there for the companies acquiring equity stake in a fully owned as subsidiary or they are acquiring some stake in joint venture then the loan can be there.

But otherwise, banks are prohibited from financing for the acquiring of shares that means, 1 can take a loan from the domestic bank and Indian company can take a loan with domestic bank to financing acquisition of shares. Similarly external, some on the components who cannot go for external commercial borrowings to do that, that all there is a restriction. You cannot take external commercial borrowings to take loans from nonresidents outside the country for acquiring capital instruments like say the rest is not there.

So, that is why the facilitating from the LBO the acquiring company has to depend on foreign lenders, foreign bankers or maybe some private equity players or venture capitalists and those can be in India as well as in foreign market for that matter.

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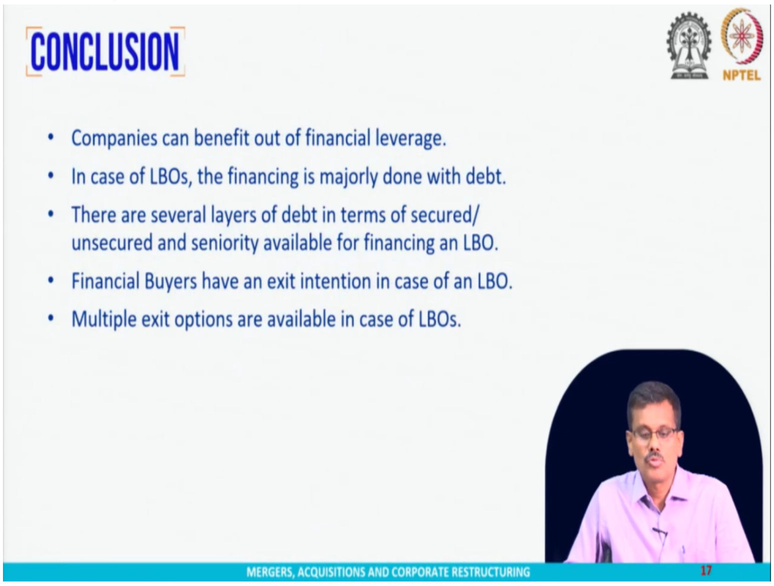


So in conclusion companies can benefit out of financial leverage in case of leverage the financing is majorly done with the debt. There are several layers of debt available, maybe secured unsecured maybe seniority and junior or senior debt for that matter for financing LBO. Financial buyers typically will have an exit of some in case an LBO and multiple exits options are also available in case of LBOs.

In the subsequent session will talk about the how financial distressed companies can take advantage of the insolvency board insolvency related act in India for that matter. So that the distressed company can they have an exit opportunity for them matter. We will discuss the last session of this particular module.

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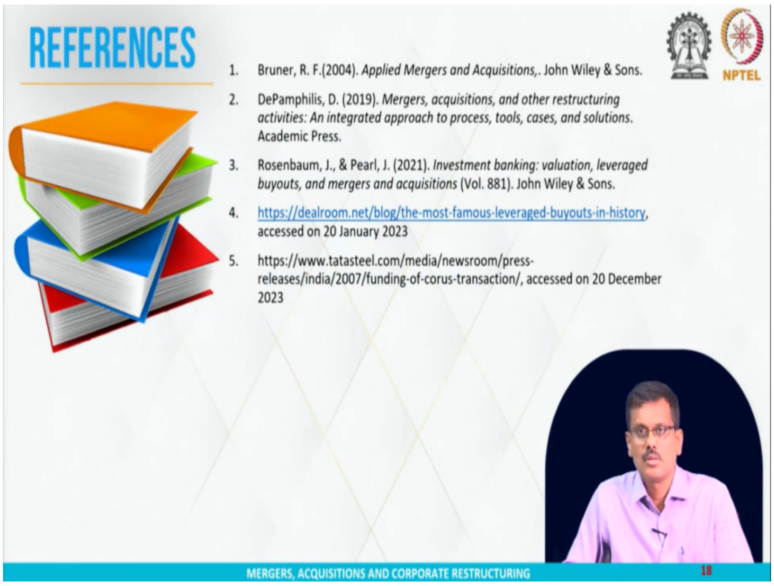


Thank you and happy learning.