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

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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 taken advantage of

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