Economic Perspective 3

LEVERAGED BUYOUTS : THE NEW GAME IN THE CITY

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Perhaps because of the huge amounts of money involved, the phenomenon of the leveraged buyout has recently been attracting much publicity. Undoubtedly, although not a new phenomenon, it is a growing one and is of increasing interest not only to the press but also to governments, regulatory bodies, unions, and academics. This perspective examines some of the more important aspects of leveraged buyouts.

The leveraged (or management) buyout has two elements. First, the management of a company buys the company from its shareholders who are the legal owners. Secondly, this purchase is largely financed by borrowing from banks and other financial institutions so that debt is used to replace shareholder equity. (Hence the term "leveraged" buyout). The management of the company thus becomes its owners, usually in partnership with the major lenders, and what had been a publicly quoted company, or part of one, becomes a private company.

The leveraged buyout takes place under various circumstances. If, for example, a company is threatened by an unwelcome takeover or predator the management, because they fear for their future, may attempt to put together an alternative bid for the company, funded by borrowed capital. This tactic has been used in America in several cases although it is not yet common in Britain. The main limit of course is the size of the company; it is unlikely that Distillers or Allied-Lyons could use this tactic to fight off predators. However, it may become more popular with medium-sized public companies with a recognised management team.

A buyout may also occur when a large company loses interest in a subsidiary because that subsidiary is no longer relevant to their operation. This is an increasingly common occurrance because so many large companies grew haphazardly in the seventies when diversification was the fashion and are now endeavouring to "get back to basics". It is not uncommon when this occurs for the large company to actively encourage a buyout and go as far as lending the necessary cash to the management. Examples of this variety of buyout in Britain were the Simplex group (a major part of which is Ayr-based Wallacetown Engineering) which had been owned jointly by the American General Electric Company and Britain's Tube Investments, and Mallinson-Denny which had been owned by Unilever.

Buyouts have also been adopted when a company is threatened by closure by its owners or its lenders, and management become owners in a desperate bid to save the company from its fate. This, of course, would not be the best of starts for a buyout operation and may not happen very often because banks will be reluctant to lend money to a declining company. However, governments or local authorities may be prepared to take a chance to prevent a sensitive closure. This has certainly been the case in London and the West Midlands.

Finally, buyouts occur, when a company is privatised by the government. This happened in the case of the National Freight Corporation but this often is obviously also limited by size. It was never likely for example that British

Telecom could have been offered to its managers in this way.

The growing fashion for buyouts is the result of a number of factors operating in the current economic environment. The most obvious of these is the takeover boom in Britain and America which is making companies increasingly afraid that they could become the victims of a predator. Even hitherto immune, very large companies (Distillers, Allied-Lyons) are feeling the hot breath of predators and it is making them all nervous. Then as already mentioned, many large companies now realise they made mistakes in their haste to diversify in the seventies and are seeking ways to make their companies more manageable by selling off what they feel are peripheral interests. What easier way than to encourage your employees to take over these peripheral operations themselves?

However, these two factors alone would not have caused the recent boom in buyouts had it not been for the fact that bankers and institutional investors were looking for safer ways of making money than lending to farmers or already overloaded debtors in South America. Management buyouts are not risk free but they have the desirable advantage to investors of substantial asset backing. Finally, a not to be underestimated factor in the buyout boom is the opportunity that brokers see to earn large sums of money in putting together attractive packages of finance and bringing together the banks that wish to lend with the managers who wish to borrow.

As with most other financial phenomenon the leveraged buyout has both its good and bad points. It will be some time before there is enough actual evidence to hand to allow us to assess them empirically and for the time being all we can do is speculate about the balance of advantage and disadvantage involved.

There appears to be two major advantages involved. First, by making the income and wealth of the mangement more directly dependent on a company's performance the buyout should encourage managers to work harder and produce better results by making the company more efficient and more dynamic. Managers are now self-employed in a sense and there is good reason to believe that this will encourage improved performance.

The second advantage is that by removing the firms from the glare of the stock market with its emphasis on short-term earnings, and the constant threat of a takeover bid, the buyout should enable managers to concentrate on long-run investment potential rather than next months earnings. This could be a good thing for the company and indeed for the economy as the example of West Germany (where the stock market is far less powerful than in Britai) demonstrates.

However, buyout is not a panacea for companies or for the economy. There are disadvantages. The major one is that by injecting so much debt into a company the company becomes extremely vulnerable to a profit decline. This is because interest charges on the debt are an extremely heavy burden on the company in the early years of its operation so that any decline in its income can lead to difficulties in covering interst payments and can lead to default. The situation is analogous to buying a house with a large mortgage. If your income is suddenly reduced below its expected level, meeting the repayments becomes extremely difficult. This is why only companies with reasonably steady prospects and competent management could or should consider a leveraged buyout.

Another disadvantage is that the buyout can act as a restraint on the company's growth because the taking on of the heavy initial debt can make it very difficult to borrow more money for expansion. In this sense a buyout already makes a company over-geared and unattrative to future lenders who worry about how the company can cope with its heavy debts. For this reason many buyout companies will not remain private for long because in order to expand they will have to tap the equity market sooner or later and again become a

public company. This is already happening to recent buyouts in America.

A final disadvantage is that buyouts can be a way of management capitalising on their insider knowledge at the expense of their shareholders. For example if management is aware of a technical breakthrough that will earn large profits in the future they could, before this became common knowledge, make an attempt to buy the company at a price which does not yet reflect its true future prospects. Laws against insider trading may make this difficult but the large amounts of potential profits involved make it so attractive that it will almost certainly be attempted and shareholders will lose out.

Future prospects

The current fashion for buyouts seems set to continue if for no other reaon than that of increasing awareness of their potential. Certainly if recent rends were to continue they could become the major financial phenomenon of the eighties (and perhaps the debt mountain problem of the nineties). However it is necessary to keep things in perspective for the time being by pointing out that some of the factors that have created the fashion for buyouts can alter suddenly (eg. the current takeover fever may abate). In addition, some buyouts will undoubtedly end in tears rather than celebrations and this will act as a brake for further buyouts. It also has to be remembered that there is a limit to the size of company that can consider this procedure. It is a relatively small firm or subsidiary phenomenon. There is no likelihood of ICI or BATS being the subject of a buyout. (The biggest buyout so far has been Mardon Packaging, owners of the Edinburgh company William Thyne, which was valued as £173m). It has to be remembered also that potential buyouts need to have stable prospects and competent managers prepared to take on major personal risks and one imagines that such companies are not thick on the ground in Britain.

Finally any growing phenomenon is going to attract the attention of government and legislators who may begin to ask whether the heavy lending involved in buyouts should continue to attract favourable tax treatment and whether the whole process should come under closer scrutiny than at present. This, I suspect, will soon be the case.

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