DEBT – DAMNED IF YOU DON'T?

HOW 99% GEARING BECAME RESPECTABLE

by DAVID SAUNDERS

Financiers of leveraged buyouts, still considered by some to be precariously risky, are using increasingly astute methods of sizing up the potential returns and building in investment safeguards.

Most people regard leverage purely as a means of enhancing wealth creation. It is my belief that leverage plays a greater role in finance than this. Not only does it create wealth, but, properly used, it ensures that the owners of assets maximise the returns they obtain. Moreover, judicious use of leverage can protect the assets against takeover.

While the use of debt increases the financial risk associated with a business, *failure* to use debt creates the danger that another party will seize control of the assets and make use of the true potential of a business at the expense of existing owners. An under-geared balance sheet presents the corporate acquirer with an under-used asset he can exploit (as was the case when Alan Bond took control of Castlemaine Tooheys).

Paradoxically, in the current market environment, heavily geared companies tend to have a low market rating and are perceived to sell at a discount to their worth. If this is right, it seems to be a case of being damned if you do and damned if you don't.

A company's reluctance to maximise its shareholders' wealth by taking on a high amount of debt may therefore be easily understandable. It reflects imperfections in market valuations. Specifically, I believe this is because the market seems to value companies based on short-term earnings adjusted for risk, whereas we in the buyout business tend to take a view on a company's medium-term value when on-sold to a third party.

Being a listed company and structuring the debt position to maximise stockmarket capitalisation, therefore, will not necessarily maximise shareholder wealth. Many of the companies we contemplate as buyout candidates are worth more as private companies than listed ones. It seems this will be the case for as long as markets remain debt-averse.

Leveraged buyouts are in two broad categories. The first, referred to as a financial arbitrage, is the original form of buyout, where the cashflow of the business is used to pay down debt. The other type, known as deconglomeration, involves the disposal of some or all of the assets of the target company. This type of transaction is also known as a wholesale/retail deal. Clearly, a combination of the two is possible and this, in fact, is the most common form of buyout in the United States.

The opportunity to achieve high returns from wholesale/retail LBOs exists for a number of reasons:

- Markets rarely price businesses at their break-up value, a value which can be achieved only on disposal of the assets. Despite the fuss about R.J. Reynolds/Nabisco, the shareholders of the company saw for the first time the opportunity to realise full value for their tobacco business, which has historically

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been marked down by stockmarkets.

Conglomerates create additional corporate costs and often impose inappropriate corporate cultures on certain businesses in the group. Deconglomeration eliminates these inefficiencies.

The high returns achieved in LBOs of this kind are a function of the fact that, although a full price is paid for the company, including a premium for control, this is financed with up to 90 per cent debt. The returns reflect this; the profits are commensurate with the financial risk of the transaction. I certainly haven't heard anyone suggest that Warwick Fairfax underpaid shareholders for the assets of John Fairfax.

If deconglomeration is the intention, therefore, there is no reason why it should not be done on the existing equity base of the company. However, the value is only realised when the management sells the assets of the company, and possibly does itself out of a job. This would be a very unusual situation in Australia, although it has become common in the US, where through the management buyout concept, management shares the "upside" with shareholders.

In a buyout structured as a longer-term investment, how does one determine the amount of debt the business should carry? This involves balancing the business risk of a company with the financial risk of its structure.

In explaining this statement, let me point out that there is no single business or business risk that is best suited to a buyout. There has been much written by merchant bankers and others in an attempt to set out what constitutes the ideal leveraged buyout. As a theoretical exercise, fine. But the production of lists and criteria has little to do with the real world. I admit to having fallen into the same trap myself. When the possibility of a leveraged buyout of the Burragorang Valley Coal Mines, now Clutha Limited, was first raised with me, I was, metaphorically, dragged kicking and screaming to the first meeting, totally convinced that it would be a waste of my time, and very resentful of that fact. My pre-conceived and "academic" notion was that coal mines had none of the characteristics necessary for a successful leveraged buyout. Their disadvantages, as I saw them, included:

- undifferentiated product;
- very powerful customers;
- weak, fragmented suppliers;
- volume risks;
- price risks;
- exchange rate risks;
- high degree of unionisation.

Table 1: Leveraged Buyouts – A look back

	1984	1985	1986	1987	1988*
Volume ($USBn)	$13.8	$13.2	$41.9	$39.6	$26.5
No. of deals	113	89	123	115	93
Firm value/EBIT	NA	6.1X	11.3X	11.9X	11.5X
Price/Earnings	NA	12.4X	18.0X	23.0X	21.6X
Price/Book	NA	1.4X	1.6X	2.3	2.5X

SOURCE: IDD INFORMATION SERVICE
MULTIPLES REFLECT ONLY DEALS FOR WHICH DATA WERE REPORTED
*PRE RJR-NABISCO

Out of a possible score of 10, Clutha would have earned only one definite point, and that was for quality of management in the mines in question.

Those academic notions did not recognise that you have to be an opportunist to close any kind of financial transaction. Being in the right place at the right time is crucial. Suffice it to say that with a threat of closure over mines which had consistently generated cash, year in and year out, and a falling Australian dollar, the patron saint of corporate finance smiled on us.

So, leverage can be utilised across a wide range of activities. The most common characteristic of the LBOs I have been involved in is their lack of commonality. Some industries are more likely to bear fruit than others; high-growth businesses will be more difficult than low-growth businesses. But there are no absolute rules.

The limitations are imposed essentially by the price you have to pay, the ingenuity of the financier/packager and, to a lesser extent, the willingness of the management team to commit itself financially to the success of the buyout.

After a leveraged buyout, cashflow is the principal concern and its maximisation is the primary goal.

Having said that, the one characteristic present in *all* successful management buyouts is an ability to manage cashflow, either short-term, where one is managing asset sales, or long-term, where one is managing earnings. Before the buyout the major financial emphasis is probably on the maintenance of earnings. After a leveraged buyout, cashflow is the principal concern and its maximisation the primary goal. A consequence of this is that most successful management buyouts of the financial arbitrage type are in mature industries, with strong market positions and low capital-expenditure requirements. One of the skills necessary in approaching a potential MBO is an ability to assess business risk, so that the investment is appropriately structured to maximise the financial return without prejudicing the successful growth of the business. Following are some of the key factors that Byvest focuses on when assessing a potential buyout.

Reliability of cashflow

The key factors affecting the reliability of corporate cashflow are the business's susceptibility to economic downturns, its competitive strength in the markets it serves, and its technological maturity.

Economic downturns. Certain businesses are far more volatile than others. The building industry, including construction and building materials, is notoriously susceptible to wide swings as a result of interest-rate changes, changes in tax policies and the general health of the economy. Commodity producers and associated industries such as mining equipment, which are dependent on the commodity cycle, also show significant volatility in their cashflows. Less susceptible are businesses manufacturing producer goods for sale to other manufacturing companies, and least susceptible are those producing consumer goods. These, too, can be broken down into producers of consumer durable items, such as washing machines, which are somewhat cyclical, and producers of consumable items such as foods which are least cyclical.

In general, it is harder to effect a leveraged buyout of a business in an industry in which the level of economic activity declines as the level of interest rates increases. The foreseeable juxtaposition of reduced demand, and therefore cashflow, with increased interest rates and debt-service requirements is likely to preclude the level of gearing necessary to finance a successful buyout.

Market strength. A highly leveraged company is not just susceptible to an overall market downturn. It is also susceptible to a decline in its competitive position in the markets in which it operates. An understanding of the market and of the industry dynamics of the business to be acquired is therefore critical to an assessment of the risks associated with high leverage. Thus, companies with a secure market niche can sustain higher leverage than those without such competitive strengths. A secure market niche might be the result of selling a proprietary product protected by patents or royalty arrangements, or it may result from ownership of a "brand name". Characteristics such as these generally translate into consistently strong demand for products which are relatively free from competition. In such conditions, inflationary cost increases and the costs associated with fluctuations in interest-rate levels can generally be passed on to customers with little impact on overall demand.

Other sources of competitive strength which can help support high gearing are manufacturing or distribution advantages. Scale can produce manufacturing efficiencies which provide cost advantages over competitors. An established distribution network may be costly to duplicate, and so pose a major barrier against would-be competitors. This may be particularly important if import competition is a threat.

Technological maturity. Businesses which are subject to rapid technological change will generally not be good targets for a management buyout. Such businesses are usually high-technology, and their products may quickly become obsolete. The earning volatility which this implies is not conducive to high leverage.

That deals with the reliability of cashflow. We now have to look at:

An important reason that the overseas explosion of MBOs will be repeated here is the availability of equity.

Corporate demands on cashflow

Research and development. A high-technology company may have certain advantages (such as an established distribution network, or in the case of health items, appropriate Government approvals) which provide some comfort that its cashflow will be reliable for at least several years, notwithstanding the development of competing products. However, if it needs to incur considerable research and development expenditure to secure its longer-term future, the funds necessary to service the debt associated with a buyout may not be available.

Growth. Similar difficulties are faced in high-growth businesses, where cashflow is required for capital expenditure and to finance working capital.

Condition of plant. The need for significant capital expenditure is a problem in any leveraged buyout. Finance may be required for up-grading, or even replacement, of plant kept in production, at considerable maintenance cost, beyond its economic life. The quality of the capital plant, therefore, must be considered critically before any management buyout is put in place.

Assessment of these factors allows us to determine the level of gearing appropriate for each individual LBO. To date, the gearing has been between 80 per cent and 99 per cent.

In effecting the desired gearing levels, we have been assisted by leverage's new respectability, which reflects the confluence of two separate events.

First, the banking industry has come under pressure in the area in which, historically, it easily derived its profits — balance-sheet lending. The increased sophistication of corporate borrowers, the securitisation of the lending markets, deregulation, and disenchantment with sovereign lending have all combined to create the threatening apparition of zero balance-sheet spread. Faced with this threat, bankers have naturally looked for market niches which will support better margins. The higher-geared progeny of management buyouts represent one such niche.

Second, the banking industry has, with the advent of powerful computer spreadsheet programs, developed greater capacity to assess the risks inherent in cashflow lending. The level of technical ability and sophistication in credit assessment by the banks is far higher now than it was 10 years ago. An important reason that the overseas explosion of MBOs will be repeated here is the availability of equity. At Byvest alone, assuming a relatively conventional 10:1 debt-equity ratio for the typical MBO, we have the ability to arrange the management buyout of businesses with a current market value of $950 million.

In the past, many prospective MBOs failed because the equity component for the transaction was not available in the right time frame. This should not be a problem any longer. Provided that the equity financier is involved, up-front, in developing the structuring of the transaction, we would probably be able to commit the deal faster than even the senior lenders, or bank. Byvest's second deal, PWB Anchor, was in fact closed within three weeks. While I am optimistic about the future of buyouts in Australia, it is worth referring to the US situation and suggestions in the press that the LBOs currently taking place are precarious, aggressive and are financed by debt that is as likely to be repaid as certain Third World debt.

The table shows that both the volume and pricing of deals in the US continue to be extremely aggressive. Very little appears to have changed since October 1987 and, frankly, I too would be concerned about investing in most LBOs in the US today, particularly if one takes a cautious view of the economy and equity markets over the coming two years.

In Australia, I can assure that in the absence of extraordinary events the question to ask is not will the buyout work, but to what extent will we exceed our base case projections. □