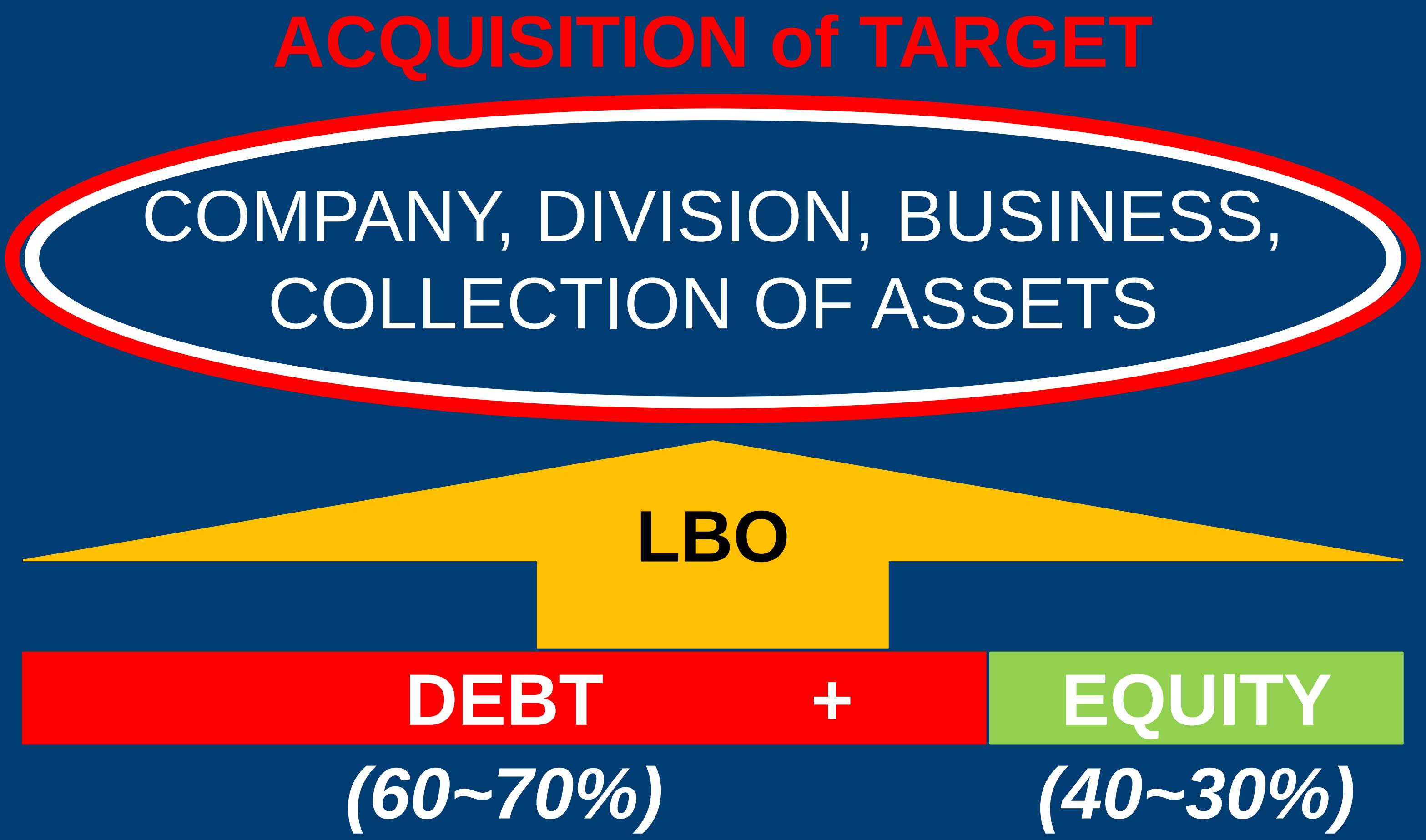
INVESTMENT BANKING

Rosenbaum & Pearl

www.investmentbankingbook.com

“Leveraged Buyouts”


ACQUISITION of TARGET
COMPANY, DIVISION, BUSINESS, COLLECTION OF ASSETS
LBO
DEBT
+
EQUITY
(60~70%)
(40~30%)

Characteristics of LBO

- 15-20% annualized return,
- exit from investment within 5 years,
- high level of debt,
- tangible asset for principal recovery,
- tax deductibility of interest expense.

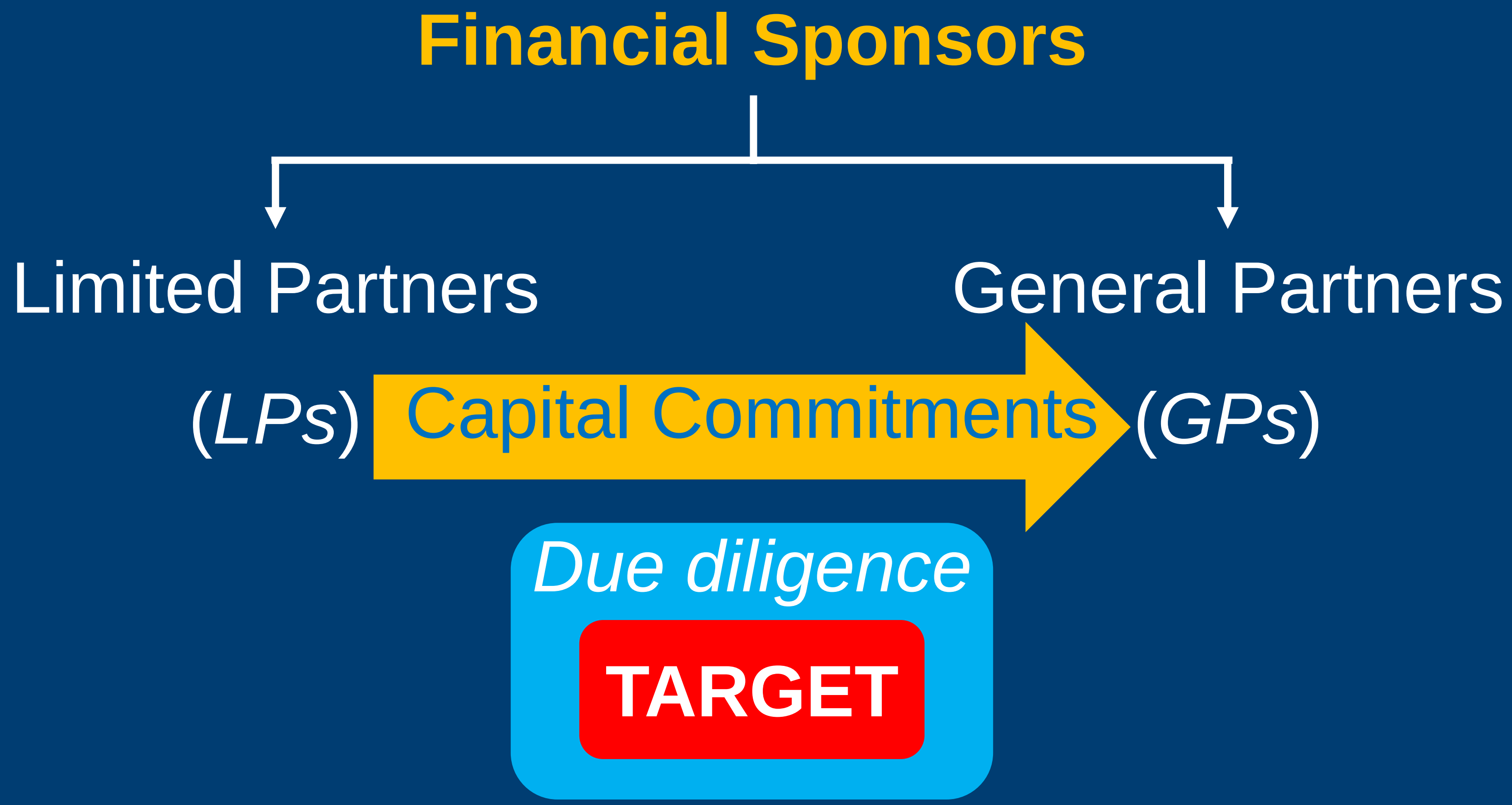
“Free cash flow is needed to service periodic interest payments and reduce the principal amount of debt over the life of the investment.”

LBO Fundamentals

- Key participants
- Characteristics of Strong LBO Candidate
- Economics of LBOs
- Primary Exit / Monetization Strategies
- LBO Financing

Financial Sponsors

- Traditional Private Equity firms (**PEs**)
- Family offices
- Merchant banking divisions of investment banks
- Hedge funds
- Venture capital funds
- Infrastructure funds
- Pension funds
- Special purpose ascuisition companies (**SPACs**)


Financial Sponsors
Limited Partners
(*LPs*)
Capital Commitments
General Partners
(*GPs*)
Due diligence
TARGET

Investment Banks

Provider & Arranger *role in*	M&A Advisor *role in*
Financing	**Due diligence**

"Investment banks perform ***due diligence*** *on LBO targets and go through an extensive internal* ***credit process****."*

Banks and Institutional Lenders

"Capital Providers for *secured debt*"

Banks

- Commercial banks
- Savings & Loan institutions
- Finance companies
- Investment banks

Institutional Lenders

- Hedge funds
- Pension funds
- Mutual funds
- Insurance compaines
- CLO funds

Bond Investors

"Purchasers of high yield bonds"

Institutional Investors

- High yield mutual funds
- Hedge funds
- Pension funds
- Insurance companies
- CDOs

Private Credit Funds

"Provider of direct loans"

- Sizable investment
- Tailored solutions
- Sourced from large institutional investors

Target Management

"Primary face of the company"

Several layers of management may participate on the post-closing basis.

INCENTIVE to improve **PERFORMANCE**

"Management Buyout"

Characteristics of a Strong LBO Candidate

- Strong Cash Flow Generation
- Leading and Defensible Market Positions
- Growth Opportunities
- Efficiency Enhancement Opportunities
- Low Capex Requirements
- Strong Asset Base
- Proven Management Team

Strong Cash Flow Generation

"Strong and predictable cash flow is critical."

What is **STRONG**

- Periodic interest payments
- Debt principal payment

"Cash flow projections are **stress-tested** based on historically and potential conditions."

Leading and Defensible Market Positions

- Entrenched customer relationships,
- Brand name recognition,
- Superior products and services,
- Favorable cost structure,
- Scale advantages.

Growth Opportunities

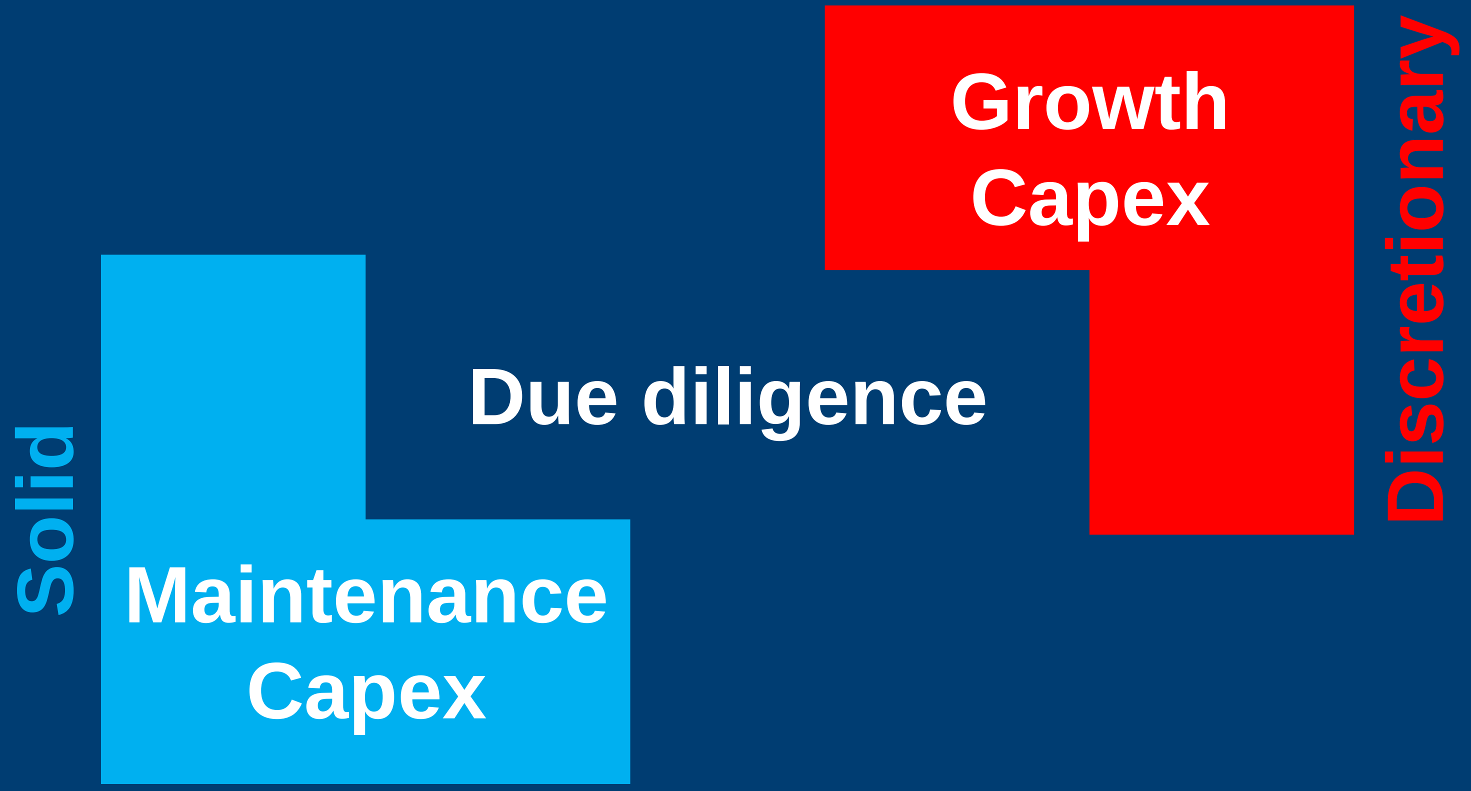
- Driving outsized returns,
- Generating greater cash for deb repayment,
- Increasing EBITDA and equity value,
- Speed in investment horizon,
- Optionality for EXIT.

Efficiency Enhancement Opportunities

establishing *“best practices”* at the target

- Lowering corporate overhead,
- Streamlining operations (Lean manufacturing & 6σ),
- Reducing headcount,
- Rationalizing supply chain,
- NEW management information systems (MIS).

Low Capex Requirements



Strong Asset Base

"collateral against loan"

- TANGIBLE assets (in terms of portion and quantity),
- LIQUIDITY of accounts receivable and inventory.

"A strong asset base also tends to signify high barriers to entry because of the substantial capital investment required."

Proven Management Team

"Talented Management"

Prior experince in;

- Integrating acquitisions,
- Implementing restructuring initiatives.

"The sponsor usually seeks to keep the existing ***STRONG*** *team in place post-acquisition."*

Return Analysis

Internal Rate of Return (IRR)

PRIMARY METRIC measuring TOTAL RETURN

(*incl.* additional equity contributions, dividends)

SHORTER EXIT → **HIGHER IRR**

Return Analysis

IRR Timeline

(Equity Contribution) Year 0		Dividend/ (Investment) Year 1		Dividend/ (Investment) Year 2		Dividend/ (Investment) Year 3		Dividend/ (Investment) Year 4		Dividend/ (Investment)/ Equity Proceeds Year 5		
$-CF_0$	+	$\frac{CF_1}{(1+IRR)}$	+	$\frac{CF_2}{(1+IRR)^2}$	+	$\frac{CF_3}{(1+IRR)^3}$	+	$\frac{CF_4}{(1+IRR)^4}$	+	$\frac{CF_5}{(1+IRR)^5}$	=	0

Acceptable **IRR threshold** within **15~20%** over **5-year**.

Return Analysis

Generate Cash Return

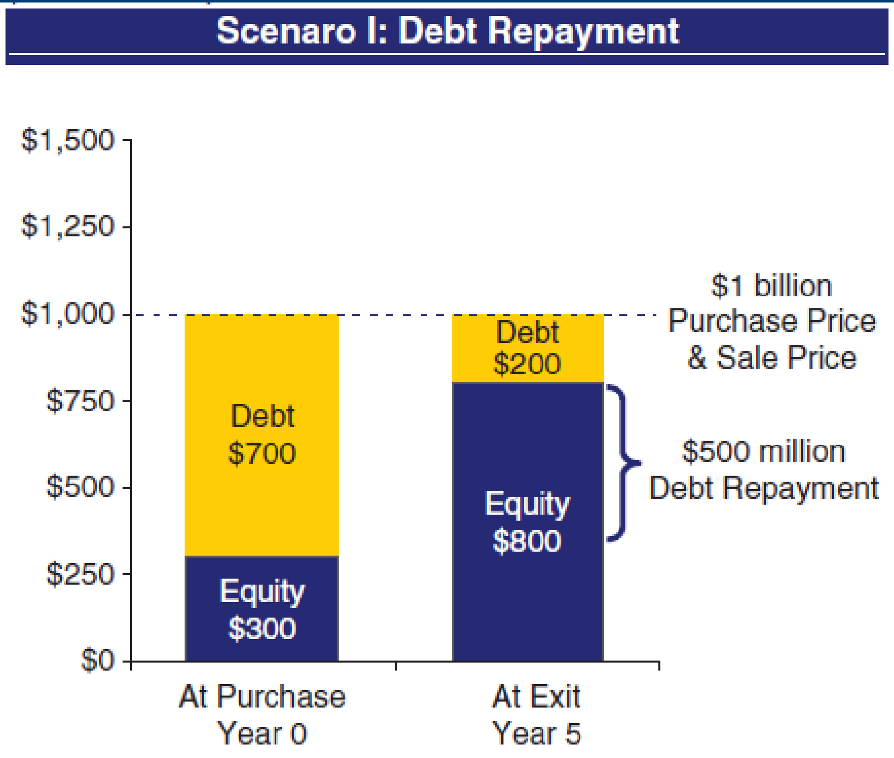
A sponsor **purchases** a company for **$1 billion.**

$700	**$300**
DEBT	**EQUITY**

In two scenarios following, the returns are equivalent on both an IRR and cash return basis.

Return Analysis

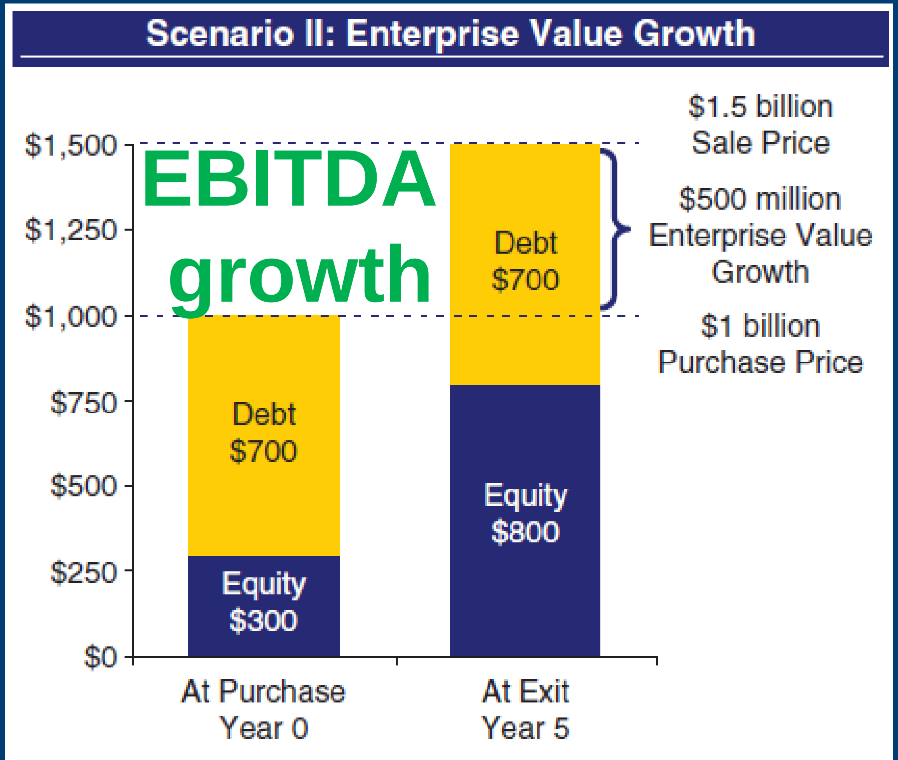
Scenario I



Debt Repayment with No Enterprise Value Growth	
Assumptions	
Purchase Price	$1,000
Equity Contribution	300
Debt Repayment	500
Sale Price (Year 5)	$1,000
Equity Value Calculation and Returns	
Equity Contribution	$300
Increases to Equity Value:	
Increase in Enterprise Value	-
Decrease in Debt from Repayment	500
Equity Value At Exit	**$800**
IRR	**21.7%**
Cash Return	**2.7x**

Return Analysis

Scenario II



Enterprise Value Growth with No Debt Repayment	
Assumptions	
Purchase Price	$1,000
Equity Contribution	300
Debt Repayment	-
Sale Price (Year 5)	$1,500
Equity Value Calculation and Returns	
Equity Contribution	$300
Increases to Equity Value:	
Increase in Enterprise Value	500
Decrease in Debt from Repayment	-
Equity Value At Exit	**$800**
IRR	**21.7%**
Cash Return	**2.7x**

Return Analysis

Leverage to Enhance Returns

Assuming a fixed enterprise value at exit, i.e., **$1.5 billion**

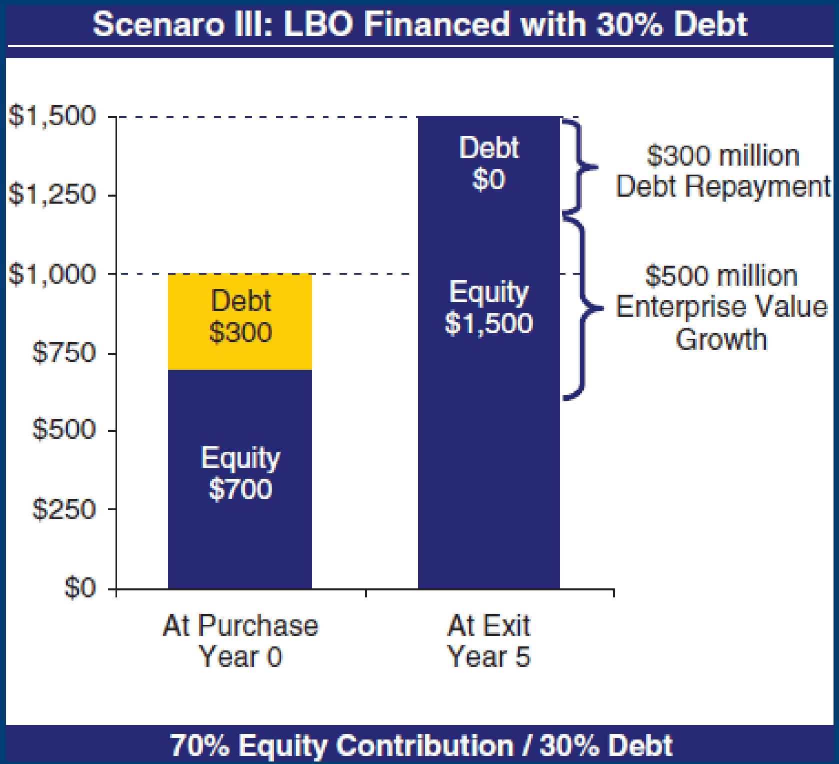
Scenario III **$700** **$300**

vs.

Scenario IV **$300** **$700**

THE HIGHER RISK, THE HIGHER RETURN GENERATED?

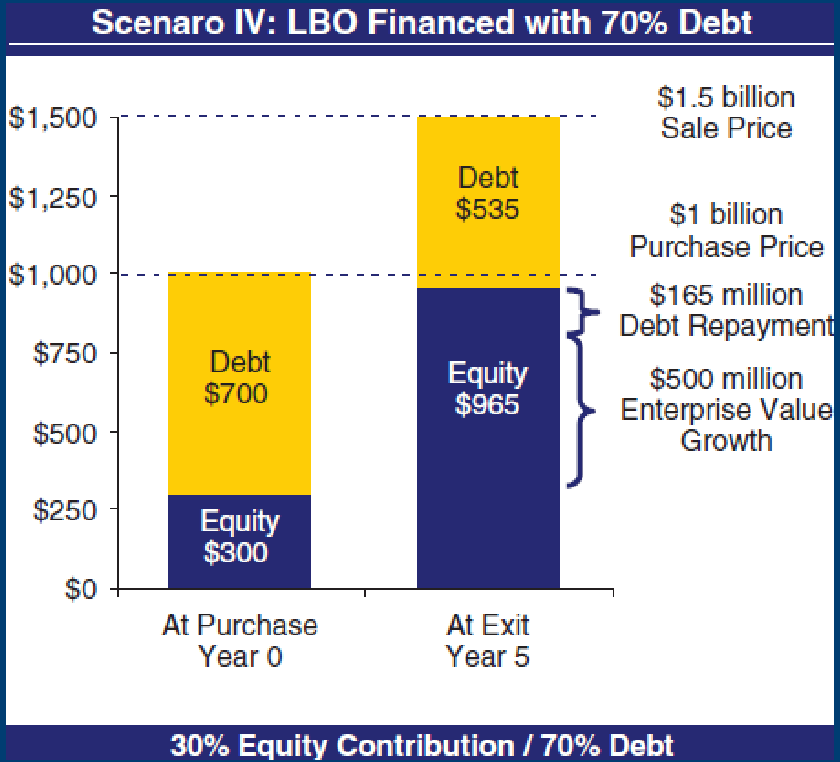
Return Analysis
Scenario III



Assumptions	
Purchase Price	$1,000
Equity Contribution	700
Cost of Debt	8%
Cumulative FCF (after debt service)	300
Sale Price (Year 5)	$1,500
Equity Value and Returns	
Equity Contribution	$700
Increases to Equity Value:	
Increase in Enterprise Value	500
Decrease in Debt from Repayment	300
Equity Value At Exit	**$1,500**
IRR	**16.5%**
Cash Return	**2.1x**

Return Analysis

Scenario IV

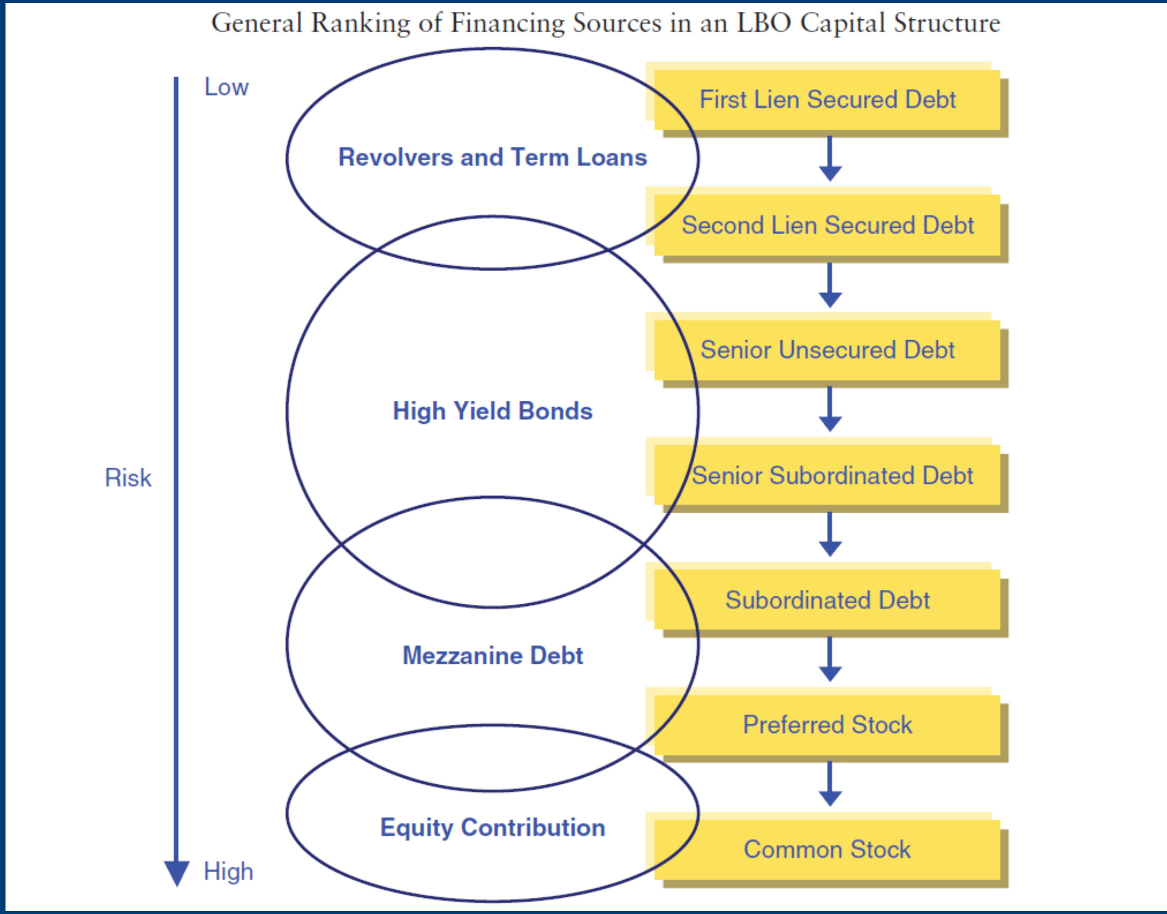


Assumptions	
Purchase Price	$1,000
Equity Contribution	300
Cost of Debt[(a)]	8%
Cumulative FCF (after debt service)[(b)]	165
Sale Price (Year 5)	$1,500
Equity Value and Returns	
Equity Contribution	$300
Increases to Equity Value:	
Increase in Enterprise Value	500
Decrease in Debt from Repayment	165
Equity Value At Exit	**$965**
IRR	**26.3%**
Cash Return	**3.2x**

Primary Exit / Monetization Strategies

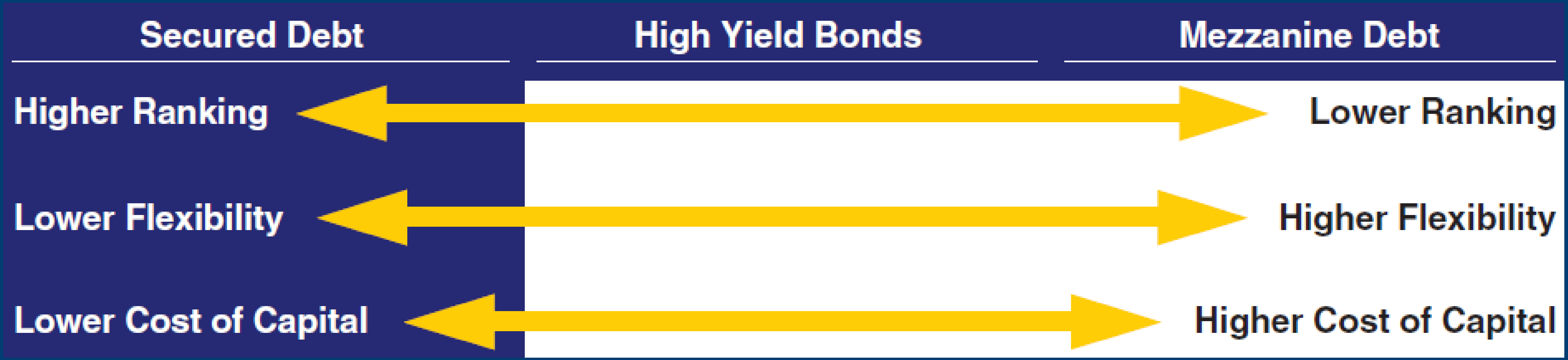
- Sale of Business
- Initial Public Offering
- Dividends / Dividend Recapitalization
- Below Par Debt Repurchase

LBO Financing: Structure



LBO Financing: Primary Sources

Secured debt (bank debt) is an integral part of LBO.



The revolving credit facility may take the form of “cash flow.”

LBO Financing: High Yield Bonds

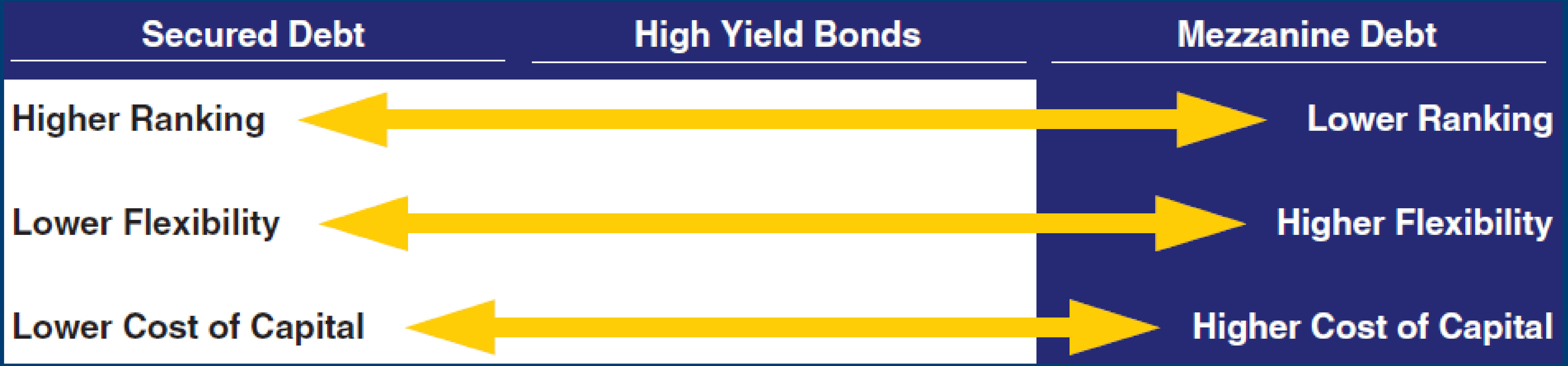
High yield bonds are non-investment grade debt securities.

Secured Debt	High Yield Bonds	Mezzanine Debt
Higher Ranking		Lower Ranking
Lower Flexibility		Higher Flexibility
Lower Cost of Capital		Higher Cost of Capital

High yield bonds feature a higher coupon than secured debt to **compensate** investors for the greater risk.

LBO Financing: Mezzanin Debt

High yield bonds are non-investment grade debt securities.



High yield bonds feature a higher coupon than secured debt to **compensate** investors for the greater risk.

LBO Financing: Equity Contribution

- Equity contribution by the financial sponsor
- Typically provided in the form of common equity
- Ranges from approximately 30% to 40%
- Provides a cushion for lenders and bondholders
- Rollover/contributed equity by existing management

Summary of LBO Financing

Secured Debt	High Yield Bonds	Mezzanine Debt
Secured	← **Security** →	Unsecured
Senior	← **Seniority** →	Junior
Shorter	← **Maturity** →	Longer
Lower	← **Coupon** →	Higher
More Prepayability	← **Call Protection** ←	Negotiated
More Restrictive	← **Covenants** →	Less Restrictive

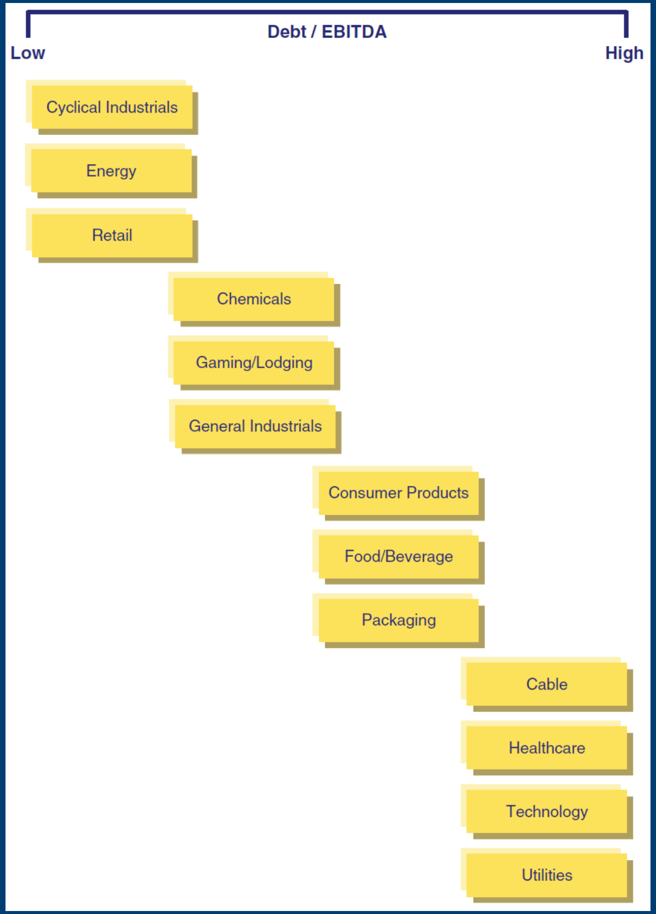
LBO Financing: Determining Financing Structure

Determining structure is mix of **ART & SCIENCE**

- Cash flow
- Returns
- Credit statistics
- Market conditions
- Precedent LBOs

The **NEEDS** of the sponsor, investors, company, management which are **NOT** necessarily **ALIGNED**.

Sector Leverage Dynamics



THANKS

FOR LISTENING