Leveraged Buyout (LBO)

Leveraged Buyout (LBO) refers to the purchase of a company that uses borrowed money for a substantial portion of the purchase price. If the purchasers are management, the acquisition is sometimes called a "management buyout" or a "management leveraged buyout."

The phrase usually refers to a purchase of a company using moneys borrowed from the seller or a third party lender for part of the purchase price. The remainder of the purchase price usually comes directly from new management and outside investors, often venture capitalists.

Three factors generally are considered essential to conducting a successful leveraged buyout: the ability to borrow significant sums (leverage) against the company's assets; the ability to retain or attract a strong management team; and the potential for each participant's (including management's) investment to increase substantially in value. The ability of a company to support significant leverage depends upon whether it can service the principal and interest payment obligations that accompany that leverage. This, in turn, requires a selling company that is capable of generating large sums of cash on a regular basis or that has substantial assets that can be sold to pay off the debt. This usually means a company with a history of operations sufficient to support the borrowing required to fund the deal.

Attracting a strong management team usually means that the division or company being purchased has a strong management team in place that requires few or no changes to make it complete. It is, after all, the investor's and lender's confidence in management's ability to run the company profitably and to expand its operations that make the buyout possible. Attracting and keeping good management also means cutting them in for a significant portion of the deal. In other words, management usually acquires a healthy percentage of the company's equity. This motivates them to stay with the company and make it grow.

The potential for increase in value of the company's stock comes not only from the ability of strong management to build on an existing base of business but also on the very fact of leverage. The heavy borrowing undertaken to complete a buyout is customarily made directly by the company. This borrowing, because it is large in comparison to the value of the assets of the company, decreases the "value" of the company's stock, enabling management and the outside investors to acquire it at lower prices that reflect the company's value as reduced by the leverage. The leverage results in the common stock having a "value" that is low in comparison to the underlying market value of the company's assets and its historical level of earnings. As the company's debt is paid off, the value of its stock increases, creating wealth for the investors. (It also helps if the underlying assets of the company were significantly depreciated when purchased so that they appear at low book values on the company's financial statements.)

As might be expected, sophisticated cash flow analysis is essential to structuring a successful leveraged buyout. Failure to properly project the company's ability to service the debt placed on the company can doom a buyout to failure. This, coupled with the number of parties typically involved in a buyout, and the variety and complexity of the financial structures needed to accommodate the divergent interests of the parties involved almost always requires the involvement of experienced professionals. These include leveraged buyout specialists, investment bankers, accountants, and lawyers.

Leveraged buyouts, when lead by existing company management, often involve sensitive negotiations with the company's Board and shareholders. These negotiations can be difficult because company management must weigh the risk to its job security created by suggesting a leverage buyout against the necessity of conducting those conversations to determine whether the buyout is possible. Price negotiations can be particularly sensitive since management, not the parent company, is often better equipped to evaluate the company, and management has an incentive to keep the price low. These conflicts can make negotiations intricate and sometimes require the use of an intermediary in the initial stages. See: Debt Service, Earnouts, Earnups, Flip, Leverage.