Leveraged Buyouts
FACT SHEET

What Makes a Company a Good LBO Target?

- Undervalued
- Stable cash flows
- Exit opportunities
- Potential for increased operational profitability (i.e. margin improvement by cost rationalization)
- Strong management team
- Low CapEx (Capital Expenditure) and OWC (Operating Working Capital) requirements

LBO Exit Strategies

Exit	Pros	Cons
Sale to Third Party Strategic Buyer	Usually full exit; buyer will pay for synergies	Typically less support from management
Distributions to Shareholders (Special Dividends and Recapitalizations)	Allows partial liquidity to equity holders	Subject to market conditions
Another LBO	Full liquidity	Less potential for operational improvement
IPO	Wider pool of potential investors	Usually only a partial exit; IPO "discount"

Internal Rate of Return (IRR) = $((\text{Exit equity} \div \text{Entry equity})^{(1 \div \text{Years})}) - 1$

Max Entry Equity for given IRR = $\text{Exit equity} \div (1 + \text{IRR})^{\text{Years}}$

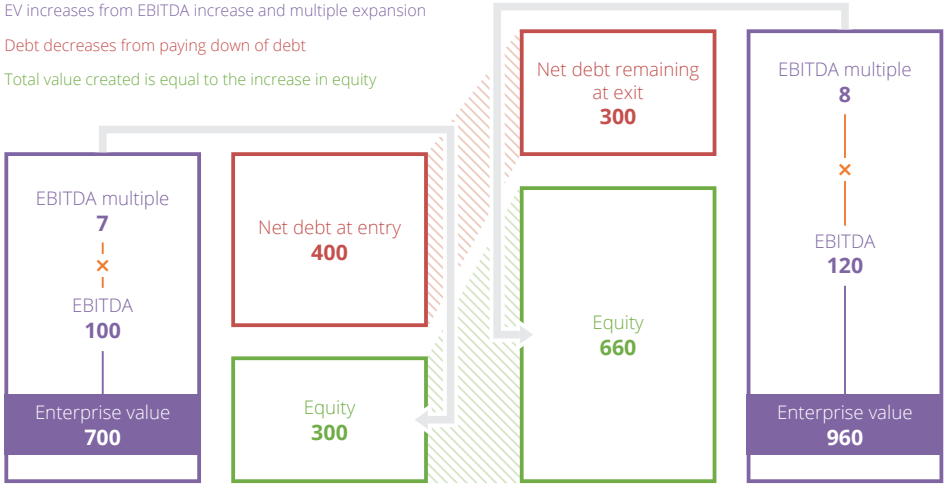
Value Creation

Entry Valuation | **Exit Valuation**

EV increases from EBITDA increase and multiple expansion

Debt decreases from paying down of debt

Total value created is equal to the increase in equity



Value Created
DECOMPOSED

+ **Debt Repayments**	**100**
= Entry debt − Exit debt	
+ **EBITDA Improvement**	**140**
= (Exit EBITDA − Entry EBITDA) × Entry multiple	
+ **Multiple Expansion**	**120**
= (Exit multiple − Entry multiple) × Exit EBITDA	
Value Created	**360**
= Exit equity − Entry equity	

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Sample Valuation

Year	0	1	2	3
EBITDA	200	203	207	210
EBIT		183	187	188
Tax rate		35%	35%	35%
NOPAT		119	121	122
Depreciation		20	20	22
Capex		(21)	(21)	(23)
(Inc) Dec in OWC		(1)	(1)	(1)
Free cash flow		117	119	120

Entry	
Entry EBITDA multiple	8x
Entry EBITDA	200
Acquisition enterprise value (8 × 200)	1600
Max debt/EBITDA multiple	5x
Acquisition debt (5 × 200)	1000
Entry equity (1600 − 1000)	600

Exit	
Exit EBITDA multiple	8x
Exit EBITDA	210
Exit enterprise value (8 × 210)	1680
Sum of free cash flows (117 + 119 + 120)	356
Debt remaining at exit (1000 − 356)	644
Equity at exit (1680 − 644)	1036

Equity Valuation to Achieve 20% IRR = Exit equity ÷ (1 + Target IRR)^{Years} **600** = 1036 ÷ (1 + 0.2)^{3}

+ Acquisition equity value
+ Refinance existing net debt
+ Debt financing fees
+ Advisory fees
= Total uses of funds
− Total debt raised
= Equity Financing Required

+ EBITDA
− Cash taxes
+/− Changes in OWC
+/− Change in other long-term assets and liabilities
− Capex
= Cash available for debt service
− Total net cash interest expense*
= Cash Flow Available for Debt Repayment

* Note mezzanine (Payment In Kind, PIK) is a non-cash charge

Credit Ratios

Total debt* ÷ EBITDA
Total debt* ÷ (EBITDA − Capex)
EBITDA ÷ Cash interest
(EBITDA − Capex) ÷ Cash Interest
FCF ÷ Total debt

* Total debt excludes preference shares

Percentage of Equity to Total Consideration = Equity financing required ÷ Total sources of funds

LBO Term Structure

SENIOR SECURED DEBT (BANK LOANS)	
Revolver	Revolving credit facility from bank used to finance short term working capital
Term A	Amortizing repayment
Term B	Bullet repayment
Term C	Bullet repayment
Second Lien	Paid after first lien / senior debt structured as a bullet repayment, usually priced with a fixed interest rate.
Unitranche	Used in medium / smaller transactions where a single debt tranche is faster and simpler to arrange with a small group of lenders.
Bridge Loan	A short-term loan to bridge the time period between completion and a refinancing such as a bond issue or sale and leaseback of assets. Will normally last up to a year and have increased interest or dilutive implications if not repaid in time

SENIOR UNSECURED DEBT	
High Yield Notes	Available to the public, these notes are a junior source of debt financing and as such command higher interest rates to compensate holders for their increased risk.
SUBORDINATE DEBT	
Mezzanine	Structured as a loan – usually with a fixed interest rate, plus the benefit of warrants on the common equity. Interest is usually Paid In Kind
OTHER DEBT	
Shareholder Loans	Equity-like risk but can be more tax efficient since interest is tax deductible
SPONSOR AND MANAGEMENT EQUITY	
Preferred Equity	Provided by the financial sponsors. Fixed dividend rate usually Paid In Kind
Common Equity	Provided by the financial sponsors, management, and sponsor executives. Generally, no dividends are paid. Management equity is a key component to keep them incentivized.