DOI: 10.54254/2754-1169/25/20230505

Advantages and Disadvantages Analysis and Legal Risks of LBO

Junhao Zou[1, a, *]

[1]*Institute of International Law, East China University of Political Science and Law, Longyuan Rd., Shanghai, China*

a. 210606020049@ecupl.edu.cn

**Corresponding author*

Abstract: The leveraged buyout (LBO) is an important and genius operation in the field of mergers and acquisitions. Companies expand and optimize their performance with the help of LBOs. The market as well as the society can also benefit from LBOs. But however, all coins have two sides. There are a lot of negative cases that illustrate that the LBO is not an impeccable operation. Shareholders' benefit can be harmed and there are insider buyouts when managers impose on their shareholders as they are privileged with their insider power. This paper is going to discuss the advantages and disadvantages of LBOs.

Keywords: LBOs; advantages; disadvantages; risk

1. Introduction

Since 2020, the world economy and market have taken a heavy blow and have shown a sign of degeneration. It's really significant in the field of mergers and acquisitions. However, there is always an operation we can count on -- the leveraged buyouts (LBOs).

A leveraged buyout is a unique type of transaction in M&A financing, characterized by relatively aggressive financial and business objectives, high leverage, and a high degree of flexibility given to the company in the financing documents. Most leveraged buy-out sponsors are financial investors that are represented by private equity funds. They have access to large sums of money and look to choose companies with high profit potential across a variety of geographies and industries in order to increase their return on investment. Statistics show that in recent years, in international leveraged buyout deals, the sponsors' median time holding the target company is 4.5-5 years, and 25-35% of the target companies are held by the sponsors for less than 3 years. We can see that in leveraged buyouts, the objective of financial investors is to drive a successful exit, push the underlying firm to go public, or boost the valuation of the underlying company as soon as possible in the short to medium term. As we can see, there is no doubt that LBOs do have lots of advantages, but there are also concerns. For example, it would seem that the public shareholders did not receive the full worth of the companies they originally held if companies were taken private and then, within a very short period of time, were brought back to the public at a significant increase in value [1]. Therefore, we are going to compare the advantages and unfairness of LBOs and to see if there are any regulatory or legislative solutions to solve the problems.

DOI: 10.54254/2754-1169/25/20230505

2. Principles of LBOs

Leveraged buyouts (LBOs) are a unique method of business acquisition. Its uniqueness is reflected in its debt-financed acquisition mode, which means that the acquisition subject typically uses financial leverage to increase the debt ratio, integrates liabilities through the capital market that are several times higher than equity funds, purchases and reorganizes the acquisition object, and then makes it more profitable, or keeps it operating, or sells it on the market. Equity investments typically make up 10% to 20% of a leveraged buyout's financial structure, while debt makes up 80% to 90%.

The majority of LBO businesses only guarantee the target company's assets and potential future cash flows, not the associated debt funding. This is a novel kind of acquisition that has emerged outside the mainstream of the economy, like a lot of significant developments in economic life. Leveraged buyout was initially developed on the periphery of finance, but due to its application, it has progressively developed into a potent financing acquisition technique. Due to its extensive use of financial instruments and leverage, leveraged buyouts—which were originally developed outside of the realm of finance—have gradually developed into a potent financing acquisition technology that has a significant impact on the capital market, corporate governance, and value creation [1]. Leveraged buyouts first arose in the 1970s, grew quickly in the 1980s in the US, UK, and other western nations, and peaked in the late 1980s. From the perspective of merger and acquisition scale, the average value of each leveraged buyout increased from 50 million dollars in the early 1980s to 300 million dollars in 1989, a six-fold increase. In the US, there were less than 100 leveraged buyouts in the early 1980s, but by 1989 there were nearly 4,000. There were a few occasions when large mergers and acquisitions totaling greater than $1 billion took place.

For example, the largest leveraged buyout in history was in 1988. KKR teamed up with Morgan Stanley, Merrill Lynch and Drexel Burnham Lambert to buy RJR Nabisco in a deal valued at $24.8 billion, one-third of the total value of LBO deals that year. From 1985 to 1989, leveraged buyouts accounted for 20% of the total value of corporate mergers and acquisitions in the United States, and more than 2,500 companies and funds engaged in leveraged buyouts. LBOs were at their most prosperous in 1986-1988, their peak year, when deals reached $88 billion. Leveraged buyouts cooled off in the 1990s, then began to recover and soar in the late 1990s, reaching $62 billion in 1999 [2].

3. Advantages

Leveraged buyouts are very clever, and they have huge advantages both in the market and in terms of the enormous value they add to the business, as was previously mentioned.

3.1. Increase Market Flexibility

Leverage, which appears in the acronym of the LBO, is its most important feature. In LBOs, purchasing businesses typically make only modest financial contributions. The majority of the funding comes from institutional loans, bank mortgages, and the sale of junk bonds, which are secured by the assets, potential cash flows, and earnings of the acquired business and used to pay principal and interest on the bonds.

Leveraged buyouts enable small, well-run, and ambitious companies to scale up and collaborate in mergers and acquisitions because the acquirer can buy a significant portion of the target company for a relatively small amount of free capital [3]. This implies that smaller businesses will have access to the same range of options for future business planning as larger businesses that run profitably with more cash on hand.

Leveraged buyout can help the market optimize the allocation of resources and improve the efficiency of asset use. Leveraged buyout fully reflects the competition law of survival of the fittest

DOI: 10.54254/2754-1169/25/20230505

under market economic conditions. If the stock price of a large enterprise is too low due to poor management and poor performance, it may be merged by a small and medium-sized enterprise with high efficiency, and the size of the enterprise will no longer be the protection umbrella of the management. Leveraged buy-out can help the market quickly eliminate enterprises with poor management and low efficiency, while enterprises with good efficiency can expand their strength and enhance their competitiveness through continuous mergers and acquisitions of other enterprises.Such leveraged buyout can drive the adjustment of industrial structure and realize the optimal allocation of resources [4].

In other words, LBO promotes market flexibility, reduces the rigidity of the property criteria for conducting purchases, and opens up additional chances for small businesses.

3.2. Enhance Market Vitality

According to some academics, private equity activity generates economic value on average based on the changes that private equity investors make to capital structures, managerial incentives, and corporate governance. These changes are also supported by empirical data on their consequences [5].

To be more precise, LBOs can benefit both the acquired firm and the acquiree companies. Unlike a hostile takeover, a leveraged buyout may involve negotiations between the two parties to make sure that the price paid by the acquiree matches the actual value of the acquired company. There is also a chance to make sure that the acquired company's future business strategy is in line with the original plan. From the acquiree's perspective, if the company is genuinely in trouble, the leveraged buyout unquestionably "rescues" the company's future and may even stop it from getting worse. LBO may be able to prevent the company's insolvency in this way.

After that, LBOs have synergy under typical circumstances. It may also produce benefits that would not have been available to the acquired firm as an independent entity if a company with a stronger corporate governance structure acquires a company with a weaker corporate governance structure and extends the former's governance structure to the latter. These advantages, usually referred to as "economic value," are produced by the acquisition. This surely makes the company more competitive on the market than it was before. Also, a market's full competition can stimulate it and increase its vitality.

Also, the notion that acquisitive businesses boost profits to achieve synergies and the notion that the acquiree does not want to lose control would encourage both parties to develop complementary business plans prior to the acquisition, thereby enhancing market competition.

3.2.1. Strengthen the Function of Market Regulation

Leveraged buyout financing unquestionably depends on the support of established capital markets, but the author also thinks that market stability and leveraged buyout have a certain relationship.

One reason is that the capital structures of leveraged buyouts are most closely tied to the state of the debt markets at the time of the buyout. As interest rates rise, leverage in leveraged buyouts declines. The amount that the private equity fund pays to acquire the company appears to be influenced by the degree of leverage that is available [6].

A leveraged buyout by another company is a possibility if there are issues with how the business is operating or if it is not in a favorable position relative to the competition. LBO lowers the threshold for mergers and acquisitions, subjects an enterprise's business operations to investor oversight on the global capital market, encourages more compliant corporate governance, and improves the supervision function of the global capital market [7].

DOI: 10.54254/2754-1169/25/20230505

3.2.2. Private Equity Creates Economic Value

After leveraged buyouts, private equity activity typically results in significant operating improvements [8]. Private equity firms discover appealing investments, create value development plans for those investments, and carry out the value creation plans using their understanding of the industry and operating procedures. Additionally, because managers must pay interest, principal, and benefits, leverage puts pressure on them to spend money prudently [9]. Leverage increases the private equity firm's anticipated returns. If all goes according to plan, PE firms can generate a sizable return on equity (ROE) and internal rate of return (IRR) with the least amount of their own capital invested. The use of leverage in an LBO is essential to obtaining the specified IRRs (usually 20-30% or greater) because PE firms are paid according to their financial returns. Leverage will be used to the fullest extent possible by private equity and leveraged buyout companies to increase the internal rate of return (IRR) on their investments.

Leveraged buyout events, such as an excessive increase in stock returns, typically have a major impact on a company's short-term market performance. Companies should use leveraged buyout tactics with caution, nevertheless, and carefully consider the acquisition's risks. In addition, the timing of the acquisition should be reasonable, and the acquisition strategy should be based on the industry trend.

3.3. A More Expert Management Teams

Specialization is being fueled by fiercer competition for projects, which calls for the management teams of private equity firms to be more competent, organized, and aggressive when it comes to the terms of a leveraged buyout. The majority of private equity firms today employ operational and industry knowledge to enhance the value of their assets [10].

In fact, the majority of the best private equity firms are now structured according to industry. Private equity companies today frequently employ dealmakers with operating histories and an industry emphasis in addition to dealmakers with expertise in financial engineering. In general, an effective team produces more money to the advantage of the business.

Additionally, in order to attract private equity investment, the company should concentrate on building a strong management team, improving the corporate structure, particularly the board of directors’ structure, and, once it has secured private equity financing, actively utilizing the management expertise, resource advantages, and brand effect of private equity to broaden investment channels and support its development.

In reality, private equity firms prefer to target mature companies in well-established industries for leveraged buyouts rather than startups or more risky ones because they are the most desirable types of businesses. The best LBO candidates often have solid, consistent operating cash flows, well-established product lines, effective management teams, and workable exit options so that the purchaser can make gains.

After all, a leveraged buyout (LBO) occurs when one business tries to acquire another while borrowing a sizable sum of money to do so. The assets of the acquired company may be used as collateral against the bonds that the acquiring company issues against the combined assets of the two businesses [11]. Global Private Equity Report 2020: Public vs. Private Markets Large-scale LBOs saw a revival in the 21st century, despite being frequently perceived as a predatory or hostile action.

4. Disadvantages

4.1. Shareholder's Benefit Got Harmed

4.1.1. Acquire Companies at a Low Price

Despite these alleged advantages, some scholarly and popular critics of the LBO continue to charge it with violating management's fiduciary responsibility to shareholders and abusing its insider status. This criticism is not unfounded, but it does present a risk [12]. For instance, insiders may decide to "take it private" by purchasing the company from the shareholders if they believe there is a significant disparity between the going stock price and the value they can obtain by dismantling, selling off, or reallocating the assets of the company [13]. The offered price at this point may be higher than the stock market price, and the company's shares are once more offered for sale to the general public shortly after the insiders have acquired them, indicating that the public shareholders may not have received the full value [14]. Public shareholders can be duped in this way because, due to informational gaps, any premium offered by management over the market price may not fully compensate them for the value of their ownership interest. Furthermore, stock traders outside of the company's management are unable to determine the value of the assets at their highest potential when put to their most efficient use. As a result, the market does not function as a really efficient pricing mechanism and instead undervalues publicly traded stock because its owners have little influence over business policies.

The negative implications of these buyouts on the firm's previous creditors have also been questioned by observers, therefore some have claimed that all similar transactions should be regarded as fraudulent conveyances. However, this is a somewhat severe example.

In reality, though, there must be two elements present in order to presume fraudulent conveyances. First, the assignment's debtor did not obtain fair value, and second, the debtor was experiencing a financial emergency at the time of the assignment. Yet, in reality, management typically buys back enterprises for a fair price, making it challenging to identify this as a fraud in real life.

4.1.2. Minority Shareholders' Equity Suffered

All shareholders have vested rights and couldn't be made to give up their ownership interests under former corporation law. But current laws give dominating investors the freedom to restructure their corporations so that minority roles are eliminated. These buyout activities are referred to as "freeze-outs" or "squeeze-outs" by commentators in a somewhat derogatory manner. They are referred to more neutrally as cash-outs or take-outs. The establishment of a totally owned shell corporation is an option for insiders who already have a controlling interest. They will become the only current shareholder of the company after they use the loan money to buy the shares directly from the target shareholders.Even though the management group had a small equity stake prior to the buyout, the same amount of stock held by management now constitutes the majority ownership of the target company following the purchase of the other target shareholders [15]. Finally, they merge the existing corporation into a shell corporation and complete such a coercive LBO.

Almost all corporate laws allow for these complex mergers when both businesses' boards of directors receive shareholder approval. Following those flimsy endorsements, the original corporation ceases to exist, and its stockholders are required to exchange their securities for cash determined by the insiders in power. These buyouts are often funded by partners of the management, who do so in return for stock and debt participation in the surviving business.

Even those requirements are optional if insiders control a majority of the company's stock—ninety percent under Delaware law. According to the part allowing short-form mergers, all they need to do

DOI: 10.54254/2754-1169/25/20230505

is create a new shell company as the corporate parent, merge it unilaterally, and pay out the minority owners.

4.2. Social Instability

In one study, private equity funds' leveraged acquisitions of sizable publicly traded U.S. companies between 1980 and 2006 were examined using cash flow statements. Researchers show that after the enterprises are under the control of private equity funds, they exhibit a dramatic drop in investment and growth by presenting the origin, ownership, and usage of cash in these transactions. On the one hand, the market is inefficient and undervalues long-term investment projects, which leads to the undervaluation of the companies that take on these projects, who then become targets for takeovers. Managers prioritize short-term earnings over long-term goals due to the pressure of takeovers and the resulting fear of being acquired at a low price. The management opted to reduce investment because the leveraged capital structure demands a shift in investment philosophy [16].

Since relatively few of these LBOs have failed so far, it is likely that the lenders carefully selected and funded them. Managers typically make fortunes from LBOs by investing relatively little and reaping spectacular profits [17]. But financial fashion has a cyclical quality to it. Some LBOs will certainly end in bankruptcy.

Another study that followed a sample of 484 leveraged buyouts and propensity score matched control firms for 10 years found that these transactions increased the target firm's likelihood of bankruptcy by about 18%, confirming that abrupt changes in capital structure raise the risk of bankruptcy and consequently increase financial distress costs.

5. Conclusion

LBOs have many benefits for the market and the economy, as well as greater cash flow and tax deductions for businesses. On the other hand, compared to regular financing operations, there are higher risks associated in LBOs. It is extremely difficult for us to determine whether LBOs are fair or efficient tools in a purely objective manner. However, we can compromise this issue by providing a trickier response, LBOs are either fair or effective tools, depending on how we choose to address the issues at hand, particularly for the government and legislators.

Only using the market to control LBOs is not always successful. Therefore, we require the assistance of the government to safeguard the entire market, the stockholders, and the businesses themselves. Many institutions have already been established in America to cope with it. In terms of policy, the government should concentrate on developing a supportive institutional environment for the growth of private equity, encourage the enactment of pertinent laws and regulations, give attention to the development of private equity talent, and enhance the exit mechanism of private equity.

Exams, interagency risk assessments of the biggest loans shared by regulated financial institutions, and data analysis from bank holding companies are the three main ways that federal banking authorities keep an eye on banks' leveraged lending activities. Other regulatory requirements, including minimal capital, leverage, and liquidity standards, supervisory stress tests, and company-run stress tests, are intended to strengthen banks' resilience and reduce credit and liquidity risks associated with lending activities.

References

[1] *Daniel J. Morrissey. (1988) Law, Ethics, and the Leveraged Buyout. U Det L Rev, 65, 403-405.*
[2] *Xvdong Guo. (2009) Research on LBO models in different financial markets. Tianjin University.*
[3] *Yongyin Shen. (2022) A brief analysis of the advantages and disadvantages of cross-border leveraged buyout -- A case study of Xiwang Food's acquisition of Kerr Company. Modern Business, 639(14), 154-156.*

DOI: 10.54254/2754-1169/25/20230505

[4] *Hairong Tang, Weijun Xv. (2013) The model of leveraged buyout and its development in Chinese capital market. Modern Management Science, 01,64-66.*

[5] *Kaplan, Steven N., Per Strömberg. (2009) Leveraged Buyouts and Private Equity. The Journal of Economic Perspectives, 23(1),121-146.*

[6] *Xiu Zhou. (2007) On the relationship between leveraged buyouts and capital markets. Southwestern University of Finance and Economics.*

[7] *Acharya, Viral, Julian Franks, Henri Servaes. (2007) Private Equity-Boom or Bust. Journal of Applied Corporate Finance, 19(4), 44-53.*

[8] *Ivashina, Victoria, Anna Kovner. (2008) The Private Equity Advantage: Leveraged Buyout Firms and Relationship Banking.*

[9] *Bergstrom, Clas, Michael Grubb, Sara Jonsson. (2007) The Operating Impact of Buyouts in Sweden: A Study of Value Creation. Journal of Private Equity, 11(1), 22-39.*

[10] *Bain. (2016) Company, Global-Private-Equity-Report-2016. Retrieved from https://doc.mbalib.com/view/a6e39ee760c94693b27019a86dd1419a.html.*

[11] *Stein. (1985) Going Private Is Unethical. Fortune, 11, 169.*

[12] *Hector. (1987) Are Shareholders Created by LBOs? Fortune, 19,98.*

[13] *Thimothy J. Burns. (1989) The Fraudulent Conveyance Laws and the LBO Lender, COM. L.J., 94, 268.*

[14] *Ayash, Brian, (2020) The origin, ownership and use of cash flows in leveraged buyouts. The Quarterly Review of Economics and Finance, 77(C), 286-295.*

[15] *Deveny, Ehrlich. (1985) Leveraged Buyouts: There's Trouble in Paradise, Bus. WK.,22,112.*

[16] *Williams. (1984) Fearing New Loan Troubles, Banks Start to Sour on Leveraged Buyouts. Wall St. J., 4,37.*

[17] *Ayash, Brian, Rastad, Mahdi. (2021) Leveraged buyouts and financial distress. Finance Research Letters, 38(C).*