Is There A Need for Improved Reporting in a Leveraged Buyout?

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by

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The ever increasing popularity of leveraged buyouts has left the accounting profession with a new area of concern. Hailed as "one of the hottest items to hit the business and investment communities in nearly a decade," a leveraged buyout involves the acquisition by a buyer of another company by pledging the value of the assets of the acquired company as collateral. Why have leveraged buyouts become so popular? Allan Sloan, in his article "Luring Banks Overboard" (Forbes, April 9, 1984), described the situation in this manner:

"It's a game that everybody seems to win. Leveraged buyouts have produced payoffs as large as 200-to-1 for some happy investors. The deals have made syndicators rich, allowed some corporate managers to become corporate owners and helped some corporations shed unwanted divisions for premium prices." 3

As the number and aggregate value of leveraged buyouts increase each year, it is evident that they have become and will continue to be an attractive business opportunity. Should the accounting profession consider the reporting requirements in a leveraged buyout? In order to answer that question, this paper will explore briefly the ingredients of a buyout, the recent history of leveraged buyouts, and finally some current danger signals which need to be examined more seriously.

BRIEF EXPLANATION OF LEVERAGED BUYOUTS

In order to understand why leveraged buyouts merit a closer look by the accounting profession, one must look in a number of different directions.

Necessary ingredients

Due to the risks involved in leveraged buyouts, lenders and equity investors must approach each transaction with caution. In particular, however, they should concern themselves with the assets and cashflow of the acquired company. Lenders are particularly interested in "hard" assets as collateral. As far as cash flow, the crucial question is: "Will the business be able to generate enough cash to service its debt?" If both assets and cash flow projections look solid, the lenders and equity investors can feel more comfortable about the risks involved in that particular leveraged buyout transaction.

The "Players"

In any traditional acquisition, you will find a seller, a buyer, a lawyer, an accountant, and perhaps an intermediary. However, as Nicholas Wallner points out in his article, "Leveraged Buyouts: A Review of the State of the Art, Part I" (Mergers & Acquisitions, Fall 1979), this changes in a leveraged buyout.
"In a leveraged buyout deal, the number of players multiplies dramatically because two separate events take place simultaneously--the acquisition itself, and a major refinancing of the acquired corporation to implement the acquisition."9

The parties involved include a number of interested buyers, such as: individuals, management groups, employee groups, and entrepreneurs.10 Lenders include commercial banks and finance companies as well as insurance companies and venture-capital companies.11 Advisory personnel, such as lawyers, accountants, merger intermediaries, and investment bankers, vary in number according to the size and complexity of the acquisition.12

The Buyout Process

According to Management Buyouts (Ernst & Whinney, 1979), there are "three important and time-consuming steps in the buyout process...determining the price for the business, preparing a proposal, and obtaining financing."13 The price is the first step in the process, and "it serves as the basis for the agreement between buyer and seller and determines the amount of debt and equity financing needed."14 The proposal must be as thorough as the situation warrants, and must include certain information, such as background information about the business, management profiles, pro forma financial data, and a description of how the transaction will be financed.15 The final, important step is finding a source for financing. Some common sources of debt and equity financing include: commercial banks and credit institutions, the seller, venture capitalists, and others.16

Now that a brief explanation of the necessary ingredients, parties involved, and the leveraged buyout process has been provided, we can proceed further and take a look at the short history of leveraged buyouts.

BRIEF HISTORY OF LBO'S

Before 1980

It is during this period of time that the popularity of leveraged buyouts began to take form. "LBO's have been around in one form or another since the early '70's, but it was only four or five years ago that the theories, language, and mechanisms came together in a cohesive whole," according to Craig R. Waters in his article "Banking on the Entrepreneur: The Leveraged Buyout Boom." 17 Nicholas Wallner acknowledged the growth of leveraged buyouts in this statement in the fall of 1980:

"Although the leveraged buyout business is growing rapidly and is becoming widely accepted, it is still a relatively quiet, low-profile investment phenomenon."

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He summarized the pre-1980 history somewhat with these comments:

"The leveraged buyout has proven a viable factor in financial circles in recent years and promises to remain an ongoing part of the merger and acquisition scene in years to come."\(^9\)

Since 1980

As leveraged buyouts increased in popularity during the late '70's, so did knowledge of the subject matter and the confidence level of all parties involved. W.T. Grimm & Co., the Chicago-based merger broker that tracks management buyouts, reported in the fall of 1983 that "the number of management deals has more than doubled since 1980, while the size of the average deal has shot from $24 million to more than $33 million during the same period."\(^{20}\) Also, the Merrill Lynch White Weld Capital Markets Group "tracked a 116% increase in LBO activity since 1979,"\(^{21}\) and projects similar results for the future. Undoubtedly, leveraged buyouts are now big business, as the market was estimated at a worth of $4 billion to $5 billion a year as far back as 1982.\(^{22}\) However, it was during the recession that year that a few people began to worry about possible dangers in the leveraged buyout market. One dealmaker said, "Leveraged buyouts used to be safe, small, and sure...today some are too damn big and dangerous."\(^{23}\) Another said, "The belief that bigger is better just does not apply to leveraged buyouts. Economies of scale here work against you, not for you."\(^{24}\) Isolated reports of companies in trouble, such as Norris Industries, Gould, Inc., Donnkenny, and Brentano, are few and far between.\(^{25}\) Yet, the danger signs continue to surface. Perhaps the best way to describe this idea is to quote Allan Sloan from his article "Luring Banks Overboard?":

"The bad news is that, like all good things, leveraged buyouts are showing signs of wretched excess. The gold-into-dross stage of LBO's is obviously at hand. What used to be a craft practiced by a handful of specialists has turned into a multibillion-dollar industry with syndicators scouring the earth doing deals, some of which don't seem to make any sense."\(^{26}\)

Why has the leveraged buyout "craze" flourished so? How long will it take for bad deals to surface and prove that LBOs are not the solution in every situation? The following is an opinion expressed way back in 1978 in Forbes that best answers these questions:

"Like all investment trends, this one will eventually be carried to excess. In their greed, investors, lenders, and brokers will start reaching for marginal
deals. Other brokers will find a way to bring the public in at an early stage, when the risk is high. There will be failures and scandals and big loan losses, and the whole game will get a bad name. But that day is still a long way off." 27

As Thomas O'Donnell states, "Is that day closer than we realize?" 28 This writer thinks so, and the profession must now examine the LBO situation and find out whether a number of current concerns warrant action through improved reporting requirements.

CURRENT CONCERNS

What danger signals are out there? Allan Sloan lists a few of them in his article "Luring Banks Overboard?": higher leveraged buyout prices, traditional lenders passing up deals because the risk is too great, the existence of blind pools, and inflated investor expectations. 29

W.T. Grimm & Co. tracked thirty-six leveraged buyouts in 1983, worth $7.1 billion, as compared to sixteen deals in 1979 worth $600 million. 30 This increase in average price per deal substantially changes the amount of risk involved. Dealmaker Jay Jordan, in his interview with Thomas O'Donnell, (Forbes, Oct. 11, 1982) emphasized this point:

"The increased debt increases the business risk a little and the financial risk enormously...This is a subjective, people-oriented business not usually appropriate for the $100 million and $400 million deals now being strung together." 31

As a result of this increase in financial risk, lenders such as General Electric Credit and Prudential Insurance have passed up a number of deals. 32 What does it mean when the pioneers of the leveraged buyout market back down? It should be a warning to the investment community, yet big banks have jumped into the picture in order to obtain the large front-end fees that boost their quarterly profits. 33

Another dangerous development in the leveraged buyout market is the accumulation of blind pools of money in excess of $50 million, some of which are being handled by companies and individuals with little leveraged buyout experience. 34 Allan Sloan had this to say about the recent trend of investment into blind pools:

"Until a few years ago most investors putting money into leveraged buyouts looked at each deal before saying yea or nay. Now figuring they have a sure thing, they tell managers to pick whatever deal seems good." 35
This blind faith in companies such as Kohlberg, Kravis, Roberts, & Co., Adler & Shaykin, and Forstmann Little & Co. shows that expectations of today's investors in LBO's has skyrocketed to an unbelievable level. A recent interview of investors in KKR by Forbes indicated that "(they) seem to expect what has been a standard LBO equity return: 8-for-1 on their money in six years." Obviously, this high expectation level cannot always be achieved.

So what should the accounting profession be doing about these alarming signals? The following section expresses my opinion on some possible actions that could be taken in order for the profession to do its part in "regulating" the leveraged buyout market before it goes bust and banks, investors, and everyone gets hurt.

CONCLUSIONS AND RECOMMENDATIONS

First of all, this writer is not one to dampen the spirits of entrepreneurial efforts. In fact, the success of leveraged buyouts up to this point has proven them to be an attractive alternative in many business situations. However, "get rich schemes" have cast a bad light on some deals. As the FASB set forth in Statement of Financial Accounting Concept #1, financial reporting should provide: information useful in investment and credit decisions, information useful in assessing cash flow prospects (amount, timing, and uncertainty), and information about enterprise resources, claims to those resources, and changes therein. This writer realizes that much of this information is provided in the written proposal prior to a leveraged buyout, but are the parties who have access to this information paying close enough attention to it? Consider the big commercial banks who have emerged as prime sources of financing. Many leveraged buyouts have led to front-end fees of up to $30 million and lending rates as high as 1.5% above the prime rate at a time when big banks cannot always get big borrowers to pay prime. At the same time, investors continue to put money into blind pools for later investment into a leveraged buyout without examining the situation at all. Consequently, the investment companies who stand to "make a killing" might reach out for marginal deals with investors' money. Meanwhile, the size of leveraged buyouts continues to increase as do the expectations of everyone involved. It would seem that the time has come for the accounting profession to tighten things up and make sure that important leveraged buyout information is available, in an understandable form, to investors and all interested parties. It is suggested that supplementary information to financial statements of companies involved in leveraged buyouts be provided. By no means will this eliminate the dangers involved in leveraged buyouts, but it will allow the
profession to serve in an "advisory" nature to uninformed investors while putting out a "word of caution" to the business community of the danger signals mentioned above. As for the future, the FASB would be well advised to research and analyze the situation in greater detail and consider an official pronouncement concerning the financial accounting and reporting of leveraged buyouts.

ENDNOTES


3. Allan Sloan, "Luring Banks Overboard?," Forbes, April 9, 1984, p. 39

4. Sloan, p. 39

5. Management Buyouts, Ernst and Whinney, 1979, p. 4

6. Management Buyouts, p. 4

7. Management Buyouts, p. 5


9. Wallner, p. 7

10. Wallner, p. 7

11. Wallner, p. 7

12. Management Buyouts, p. 6

13. Management Buyouts, p. 8

14. Management Buyouts, p. 8

15. Management Buyouts, p. 9


17. Waters, p. 52

19. Wallner, p. 25

20. Waters, p. 47

21. Waters, p. 47

22. Waters, p. 47


24. O’Donnell, p. 250

25. O’Donnell, p. 250

26. Sloan, p. 40

27. O’Donnell, p. 251

28. O’Donnell, p. 251

29. Sloan, p. 40

30. Sloan, p. 39

31. O’Donnell, p. 250

32. Sloan, p. 40

33. Sloan, p. 40

34. Sloan, p. 40

35. Sloan, p. 40

36. Sloan p. 40

37. Sloan, p. 40

38. Sloan, p. 41