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## LBO Musical Chair Q&A

So a question we received related to yesterday's article was:

> **Does the PE investor have to pay off the debt borrowed for the deal? Specifically, is the debt assumed by the investor or the Co?**

I wanted to highlight the fact many of the LBOs pay a premium above the book value, where P/B is 2.0x is cheap. As the transactions compound one after another, the subsequent buyer is paying for more goodwill, while increasing the debt load. However, if we stick to a strict regimen of buying companies closer to 1.0x P/B, then even if we are the 3rd, 4th buyer of a Co., we will still have a manageable debt load relative to the assets which secure the debt.

| Original Value | |
|---|---|
| **Asset** | **800** |
| Goodwill | 0 |
| Tangible Assets | 800 |
| **Debt** | **0** |
| **Equity** | **800** |

| 1st Acquirer | |
|---|---|
| **Asset** | **800** |
| Goodwill | 0 |
| Tangible Assets | 800 |
| **Debt*** | **400** |
| **Equity** | **400** |
| Goodwill | 0 |
| Acquisition Price | 800 |
| P/B | 1.0 |
| Disposition Price | 800 |
| Equity Return | 200% |

*$400MM debt is placed on the Co's book

| 2nd Acquirer | |
|---|---|
| **Asset** | **1200** |
| Goodwill | 400 |
| Tangible Assets | 800 |
| **Debt**** | **800** |
| **Equity** | **400** |
| Goodwill | 400 |
| Acquisition Price | 800 |
| P/B | 2.0 |
| Disposition Price | 800 |
| Equity Return | 200% |

*$400MM debt is placed on the Co's book
** Additional $400MM debt is placed on the Co's book

| 3rd Acquirer | |
|---|---|
| **Asset** | **1600** |
| Goodwill | 800 |
| Tangible Assets | 800 |
| **Debt***** | **1200** |
| **Equity** | **400** |
| Goodwill | 400 |
| Acquisition Price | 800 |
| P/B | 2.0 |

*$400MM debt is placed on the Co's book
** Additional $400MM debt is placed on the Co's book
*** Additional $400MM debt is placed on the Co's book

| Original Value | |
|---|---|
| **Asset** | **800** |
| Goodwill | 0 |
| Tangible Assets | 800 |
| **Debt** | **0** |
| **Equity** | **800** |

| 1st Acquirer | |
|---|---|
| **Asset** | **800** |
| Goodwill | 0 |
| Tangible Assets | 800 |
| **Debt*** | **400** |
| **Equity** | **400** |
| Goodwill | 0 |
| Acquisition Price | 800 |
| P/B | 1.0 |
| Disposition Price | 400 |
| Equity Return | 100% |

*$400MM debt is placed on the Co's book

| 2nd Acquirer | |
|---|---|
| **Asset** | **800** |
| Goodwill | 0 |
| Tangible Assets | 800 |
| **Debt*** | **400** |
| **Equity** | **400** |
| Goodwill | 400 |
| Acquisition Price | 800 |
| P/B | 1.0 |
| Disposition Price | 800 |
| Equity Return | 100% |

*$400MM debt is placed on the Co's book

| 3rd Acquirer | |
|---|---|
| **Asset** | **800** |
| Goodwill | 0 |
| Tangible Assets | 800 |
| **Debt*** | **400** |
| **Equity** | **400** |
| Goodwill | 400 |
| Acquisition Price | 800 |
| P/B | 1.0 |

*$400MM debt is placed on the Co's book

From our write up yesterday, if I am the 1st acquirer, a non-value investor who listens to my I-Bankers and believes in cashflow, comp multiples as a valid source for valuation, bought a $100MM EBITDA generating Co. for P/B at 1x., P/EBITDA 8x, or $800MM for equity, not enterprise value. Then zero goodwill would be created. I pitched in $400MM which is captured as equity. The remaining $400MM was borrowed. Am I liable for the $400MM debt, or does the company assume the debt on its' book?

This switch from $800MM in book value, to a $400MM in debt and $400MM is a recapitalization, a change in the capital structure using leverage. Operationally, nothing has changed. However, the value for the equity piece should have gone from $800MM to $400MM, if it followed a 1x P/B relationship. Yet, as mentioned, if the EBITDA is $100MM in both scenarios, and the comp multiple is 8x, then the equity should be selling at $800MM for each, or 1x P/B in the original and 2x P/B in the recap.

I am all about P/TBV, a sort of Net-Net Graham play. I was confused by the question because the book value went from $800MM to $400MM as a result of the recap. Then I can only sell for $400MM, if the investor community remains true to the 1x P/B multiple pre-LBO. However, if I am liable for $800MM and can only recoup $400MM, I am screwed. Yet, if the Co. is liable for the $400MM debt, and I can sell for $400MM equity, then I recoup my investment.

**Technically, the 1st buyer can be bought out at $400MM, with disregard for the debt.** For example, if a publicly traded Co. had $1BB in debt and had a market cap of $500MM, how much would the acquirer need to pay to acquire the Co? The acquirer would only need to pay $500MM to buy the equity for the Co., since the $1BB in debt was booked on the company's book.

It's different from buying real estate. Typically, buyers will pay for the house at market price and personally assume the mortgage and be held liable for the mortgage. However, if a REIT was the buyer, the REIT owner could invest 20% as the full Equity owner alongside the REIT, who assumes the mortgage for the remaining 80%. Technically, another buyer could assume the mortgage held by the REIT, and pay for the equity held by the REIT owner. The notion that the investor has to pay off the debt borrowed to consummate the deal in all situations is not withstanding.

Also, when we read of buyouts on the news, they mention stress tests to see whether the newly formed Co. could service the higher interest expense. If the Investor was personally liable for the debt, then there would be no reason for the Co's cashflow to service the interest on the debt.

**I believe the issue lies in Enterprise value vs Equity definition. When the media reports the cost of a buyout, they cite the Enterprise Value. However, we know the true cost of a buyout is only the Equity value. Why does an investor need to payoff the existing debt? They don't. The investor only needs to acquire the equity ownership. The investor will own the Co. now, which happens to carry the debt.**

**So, to answer the question, I think it depends on how the deal was arranged. If it is assumed by the Co., the debt can theoretically be kept on the books and it wouldn't matter to the investor since they are out in 5 years, which is the typical holding period. The Co. could float the debt endlessly by rolling the maturity. However, if it is assumed by the Investor, the debt will have to be repaid. .**

I was always under the assumption the investor repays what they borrowed, but ran into this chart by Macabacus.

Macabacus' chart shows the debt is issued to the NewCo, never the investor.


http://macabacus.com/valuation/lbo