

LBOs in France : Why do some fail ?

Hugo DAUGERON-MIJOIN

Traduction : Pierre-Thomas Blanc

A Leveraged BuyOut (LBO) is an operation that consists of the acquisition of the shares of a target company by a special purpose entity (created specifically for the operation and therefore with no activity of its own) and which takes out a debt to finance this acquisition. To better understand the mechanism of an LBO you can click [here](#) or [there](#).

In 2018, there were 384 LBO transactions in France. This represents only 17.31% of companies supported in French Private Equity (PE) but 65.00% in value, i.e. more than €9.5 billion invested.

Leveraged buyout capital is a very heterogeneous sector, where each transaction is unique due to its sector, ownership, business model or company-specific factors. It is therefore very difficult to identify a trend to understand what makes an LBO work or fail.

We will call an LBO failure according to the following definition: an LBO failure is characterized by at least one of the factors including i) the financial failure of the company ii) the obligation to refinance its financial debts in order to avoid financial failure iii) the breach of a covenant iv) the capital loss for a Financial Sponsor on its initial investment v) the departure of the top management prematurely. This definition of "failure" is key: carrying out an LBO is a complex operation for all players. It is therefore necessary to be precise and all the points mentioned above are synonymous with failure to respect the information that initially enabled the transaction to be carried out. Failure is not only the failure of the company, which will certainly be a failure of an LBO for all the players, but all the points mentioned can also affect at least one of the players and put them in a situation of failure.

Based on a current observation on LBOs and the evolution of their financial structuring, we will study corporate governance with the Financial Sponsors with equity to see if they have a negative impact. We will then see how the size of the company can be a determining factor in the success of the LBO. From the point of view of the financial structuring of an LBO, things have evolved well. We have gone from a pre-crisis Subprime debt ratio of around 80% to a post-crisis debt ratio of up to 50%. In addition to the debt ratio, if we look at the structuring itself, banks now avoid lending in Tranche B, the so-called "bullet" tranche, and limit it to 30% of the loan made. The tendency is therefore to lean towards Tranche A, known as amortizable (see the following tables).

Employment-Resources table for a pre-crisis LBO transaction

EMPLOYMENT	RESSOURCES
Stock values	Equity Quasi Equity (maximum 20%) High Yield Bonds (maximum 15%) Second Link (maximum 5%) Senior debt (maximum 55%)
Transaction costs	- Of which TA (30%) over 7 years - Of which TB (70%) over 8 years Mezzanine Debt (0-5%)

Source: Quiry et le Fur (2016)

Employment-Resources table for a post-crisis LBO transaction

EMPLOYMENT	RESSOURCES
Stock values	Equity Quasi Equity (at least 50%)
Transaction costs	Senior debt (maximum 50%) - Of which TA (70%) over 6 years - Of which TB (30%) over 7 years Mezzanine Debt (0-10%)

Source: Quiry et le Fur (2016)

This being said, an LBO operation requires more equity, consolidating the operation and reassuring the Lenders. The ECB has become aware of this trend and has set up the "[ECB GUIDANCE](#)" for Systemic Banks. In this Guidance, it is notified that Banks lending to companies with a Gross Debt / EBITDA leverage of more than 4 or if the financing was operated by a Financial Sponsor, should implement monitoring and risk management systems to an even greater extent.

The choice of the target under LBO is therefore crucial to know whether its business model is solid and cash generating. Then comes the importance of the Financial Sponsors who, in addition to providing equity capital and enabling the transaction to go ahead, will play a role in the success or failure of the LBO.

Governance within an LBO is totally different from that of a "classic" company. Indeed, the shareholders are represented by two players: the top management and the Financial Sponsor. By Financial Sponsor, we mean any player with a stake in the company's capital whose sole purpose is to

remain in the company for a limited but not predefined period of time. Generally speaking, these FSs are private equity funds. The objective of a FS is to maximize its initial investment. To evaluate its performance, the FS will have to have its Internal Rate of Return (IRR) higher than the cost of capital (commonly called Weight Average Cost of Capital, WACC).

There are then two strategies for FS to maximize its IRR:

- Buy and Hold (B&H)

This was the norm until the crisis of 2008. FS were investing in companies, but without really seeking to participate in their growth. It is a form of passive management where the FS builds up a diversified portfolio of companies in which it has invested and expects its return to be operating.

- Buy and Build (B&B)

As Hammer (2016) points out, FSs have been adapting this strategy since the 2008 crisis, particularly with the transformation of EP players who come to be listed on the markets and therefore have an indefinite longevity. B&B is a strategy that has a more sustainable vision of FS in the company. It is an active management that highlights the fact that the FS wants to build a real synergy with the company in which it has invested.

The FS then uses its resources ([Wernerfelt, 1984](#)), its interconnections with the different actors of the EP ([Aguilera, 2008](#)), incentive and control mechanisms (Charreaux, 1997) and its network ([Castellaneta and Gottshalg, 2016](#)) to serve the company.

However, all these mobilized resources have their limits. As [Stévenot \(2005\)](#) explains, top management alone decides to give information to the FS. While it has semi-annual and annual obligations to its other shareholders, it is the top management who decides to talk about the difficulties between these periods. It is therefore easy to manipulate information, or even hide it.

FS, of course, stays longer in the company because of its B&B strategy, on average 5.3 years (vs. about 3 years pre-crisis 2008). But the closer the exit approaches, the less the top management and the FS have a common vision on the management of the company. The FS will seek to maximize its investment, even if it means jeopardizing their partnership. Can we then really consider that the FS is a long-term partner for the company?

The last point relates to the size of the company. Not all companies have the same structure or the same business model, as mentioned above. It is therefore interesting to look at these characteristics. As we have seen, SMEs are the core target in terms of volume, but because of their structure, which may seem fragile at first glance, the associated amounts are small, thus carrying a better controlled risk. The main risk then comes from the lack of knowledge of LBO management, which can lead to failure both for the company by not carrying out the planned business plan but also by a direct confrontation

with the Financial Sponsor. The midcaps would therefore be the target that would make it possible to overcome all these shortcomings and thus become the preferred target for the success of an LBO?

Midcaps are certainly the perfect target for LBOs because they have better financial performance ([a margin rate of 25% vs. 20% for SMEs](#)), [are more international \(with an average of 5 subsidiaries abroad\)](#) and [are more diversified \(31% of midcaps take stakes in other companies\)](#), but are not infallible. Because of its "perfect" structure, the choice of target is just as important. However, LBO failure in midcaps does exist. It is even more present than one might think. According to [Souissi \(2013\)](#), breaches of covenants are more prevalent among midcaps than among SMEs. On average, midcaps have a 46% average breach of covenants. However, this fairly high figure must be qualified: SMEs are less subject to covenants, but rather to guarantees.

Then there is the question of Large Corporations: are they as powerful as SMEs in making an LBO?

The real problem for large companies is refinancing. In theory and according to calculations, everything seems to be a win-win situation for all stakeholders. However, refinancing is never a good solution and, moreover, bullet refinancing.

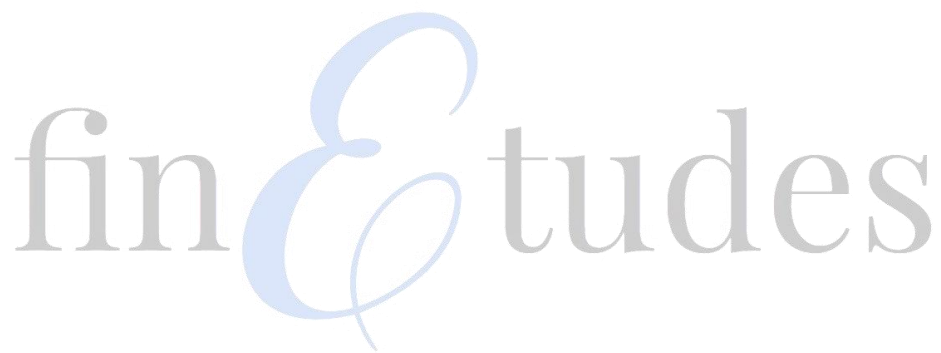
Refinancing simply means deferring the debt, and therefore the risk. Here, the risk is mainly borne by the lending bank, which believes that the large companies will not default. The past has taught us that the "too big to fail" does not exist, an awareness is needed. These refinancing operations are all the easier for the EGs as they put strong pressure on the Banks. Even if they could repay their debts, they force the Banks to accept this refinancing, leading to an over-refinancing of existing debts. Large companies are therefore not deleveraging themselves.

The Banks are also more accommodating to the large companies. The granting of loans is faster, in higher amounts and reaching very important levers. This explains a strong growth in lending to large companies: 8.1% in June 2019 YTD . The average outstanding amount of a large companies is 517 million euros compared to 0.384 million euros for an SME and 43 million euros for a midcap company.

Company size	Number of companies june 2019	Outstanding (in billions of euros) June 2019	Variation (percent) June 2019 / June 2018
SME	1 117 135	429,2	+6,4
Midcaps	6451	280,2	+4,0
Large companies	284	146,7	+8,1
TOTAL	593 609	856	+6,0

Aware of this situation, the High Council for Financial Stability (HCFS) decided to set up since 1 July 2018, for a minimum of 2 years and renewable for 1 year, a limit of 5% maximum of eligible equity capital for exposures of more than 300 million euros concerning companies resident in France. This macro-prudential measure comes at a time when large companies are heavily leveraged with very low interest rates. As the HCFS points out, the indebtedness of non-financial corporations (NFCs) has been rising steadily since 2005, especially for large companies.

This preventive measure seeks to avoid excessive and risky concentration, especially on systemic banks such as BNP Paribas, Société Générale, Crédit Agricole, BPCE, Crédit Mutuel and La Banque Postale, which cover 95% of outstanding credit. The banks concerned are responsible for identifying the considerations concerned by the measure. The Autorité de Contrôle Prudentiel et de Résolution (ACPR) is responsible for monitoring its implementation.



CONCLUSION

Can we really understand the failure of an LBO operation? Even if one can understand the financial vision, a psychological dimension is necessary and must be taken into account. Our topic on behavioural finance gives us some answers. However, it should be understood that the heterogeneity of operations, companies, management methods and shareholder involvement does not allow us to make a firm and clear statement on why LBO failures occur in France.

Even if it is not possible to say clearly how to avoid failure in an LBO transaction, we were able to highlight through our analysis some key points of attention in order to avoid failure. The financial structuring of the debt in the LBO is crucial for the viability of the operation. There has to be a balance between debt and equity, so as not to put all the players in a situation of failure through covenants that would be broken or even the failure of the company. As we have explained, the Banks have changed their post-crisis financing method for Subprime, injecting a maximum of 50% of debt with a distribution that tends more towards a Redeemable tranche than a Bullet tranche. If structuring is no longer the main factor of failure, we can ask ourselves the question if it is not the mode of governance in the company under LBO and more particularly the Management - Financial Sponsor relationship. The Financial Sponsor is key in the LBO since it allows the company to bring the equity necessary for the operation. The Financial Sponsor also brings all its resources allowing the company to be better organized, to enlarge its network and to develop new synergies. However, it is possible to have a conflictual relationship between these two actors, so that the Financial Sponsor only seeks to maximize its IRR while the Management wishes to perpetuate its company. Even if the Financial Sponsor stays longer in the capital than before the crisis due to the development of Buy and Build strategies requiring more time to generate returns, we can question the fact that it is a "long term" partner but rather a "medium term" partner who, when exiting the capital, will seek to maximize its investment rather than to invest in the company. Management also has its share of responsibility in a failed LBO: it is the management that will provide a business plan, which will certainly be challenged by audits, but is based on a strategy specific to the management. The non-implementation of the Business Plan, which is the basis on which all the LBOs in France, not only by the players but also by the Banks and Financial Sponsors, automatically lead to a minimum covenant breach, and therefore to failure.

A business plan means a business model. Our attention then turned to the structure of the company itself. In France, there are mainly SMEs. As we have shown, SMEs are the companies with the weakest performance compared to midcaps and large companies, but they are not necessarily the ones that break the most covenants. Midcaps and large companies are the ones that fail the most if we take our definition of "LBO failure". In fact, midcaps break more covenants than SMEs and large companies simply refinance their debt, which is mainly in the form of a bullet. Even if the

LBOs in France : Why do some fail ?

management is less able to be prepared and efficient in an SME LBO, the perfect target is not the midcaps as one might think. There is no such thing as the "perfect" target for an LBO. Each situation must be analysed.

In an environment that increasingly advocates "covenant lite", accounting measures that impact cash flows such as IFRS 16, and the rise of Private Equity that challenges Public Equity, more regulation is needed. While the ECB guidance enables banks to better control risk when structuring debt for debt ratios above four and the High Council of Stability temporarily regulates loans to large companies that have a real dominant position over banks, it is becoming essential to clearly define laws to limit LBO failures.

How to regulate heterogeneous transactions that are in a private sphere?



Bibliography:

AGUILERA, Ruth ; FILATOTCHEV, Igor ; GOSPEL, Howard; JACKSON, Gregory; An organizational approach to comparative corporate governance : costs, contingencies and complementarities, en ligne, Organization Science, 2008, vol. 19, p475-492

CASTELLANETA, Francesco; GOTTSCHALG, Oliver, Does Ownership Matter in Private Equity? The Sources of Variance in Buyouts' Performance, en ligne, 2016 Strategic Management Journal

CHARREAUX, Gérard, Le gouvernement des entreprises : Corporate Governance, Théories et faits, édition Economica, collection Recherche en gestion, 1997, 540p.

JENSEN, Michael, Active Investors, LBOs, and Privatization of Bankruptcy, Journal of Applied Corporate Finance 2, 1989, p35-44

JENSEN, Michael; MECKLING, William, Theory of the firm: managerial behavior, agency costs and ownership structure, Journal of Financial Economics 3, 1976, p305-360

QUIRY, Pascal ; LE FUR, Yann. Pierre Vernimmen Finance d'entreprise 2016, Chapitre 50 - Les LBO, en ligne, Edition Dalloz, 2016, p1015-1032

STEVENOT, Anne, La gouvernance des entreprises financées par capital-investissement : d'une approche juridico-financière à une approche cognitive, en ligne, Association Internationale de Management Stratégique, 2005

WERNERFLET, Birger A Resource-based vie of the firm, en ligne, Jstor, Strategic Management Journal, en ligne, No. 2 Avril – Juin, 1984, Vol. 5, p171-180

Banque de France – Bulletin de la banque de France numéro 191Bpifrance – Rapport sur l'évolution des PME 2018 BCE – Guidance 2017