LEGAL ASPECTS OF FINANCING MANAGEMENT BUYOUTS AND PRIVATISATION

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It is a privilege, albeit a somewhat daunting one, to address this conference of heavyweights in the banking and legal fraternities. I will therefore start by emphasising that I am neither a banker nor a lawyer. I merely spend 60 percent of my life cajoling or negotiating with them. Some of the cajoling has resulted in my friend John O'Sullivan developing the habit of referring to me as a "bush lawyer". I have never been able to work out whether this was a compliment or not, nor have I previously had the courage to confess my ignorance. In the spirit of a true lawyer, ignorance is something on which he always catches me out and then capitalises.

Given this, please do not expect any erudite expositions of the finer points of corporate or banking law from this speaker. I wish, rather, to focus on three issues:

The first is a banking point - the necessity that lending structures reflect the nature of the transaction. An LBO is not an LBO is not an LBO.

The second issue is that legislative "nannying" is inhibiting to the LBO market in Australia.

The third issue is that MBOs require a level playing field to thrive. Given the way the law is practised, as opposed to framed, management is presently disadvantaged. Management should be able to structure LBOs and MBOs using the same information used by major shareholders when the latter are trying to take over a business.

LENDING STRUCTURES

Let me perhaps start by giving you a simple definition. A leveraged buyout is the acquisition of a business on a highly geared basis using essentially the assets and cashflow of that business to finance it. One example which would readily come to mind of a leveraged buyout would be the acquisition by Mr Bond of Castlemaine Tooheys. A management buyout is a leveraged buyout with management involved in the equity structure as an equity player in the transaction. So, for example, when Mr Bond took over Castlemaine Tooheys, if Bill Widderberg, who was widely regarded as the best brewing man in Australia, had been an equity investor in that transaction, that would have been a management buyout.

Management buyouts can be big or small. For the bigger deals, say those which are more than $10,000,000, an LBO specialist is required to provide additional equity funds for the transaction. Management generally do not have the financial wherewithal themselves to finance a big deal.

High leverage introduces a significant element of risk in a transaction - quite clearly, the more highly geared a business, the more liable it is to some kind of failure. You offset risk with information. The more you know about a business, the greater your knowledge of how it works, its strengths and weaknesses, the more able you are to understand and assess risk. So the availability of information to the LBO specialist who is putting the deal together is a very critical part of doing management buyouts and leveraged buyouts.

So what are the key characteristics of LBOs? First, in order to get access to the information, leveraged buyouts are usually internal deals. Secondly, they are always highly geared. Thirdly, there are always a number of players involved - management, the LBO specialist or the external investor, the vendor and probably several lawyers and bankers.

Conceptually LBOs come in at least two manifestations. By far the most common world-wide, and indeed the only kind which has so far been evident in Australia, is the long-term financial arbitrage. This is an LBO driven by the recognition that capital structures have value, and costs associated with that value. A company nowadays must manage its capital structure as well as its business. As businesses age, they become more mature, they become less risky. The technologies are old and will not change drastically. The growth rates have declined. Cash flow is not needed to finance major capital expenditures, or investments in working capital. Instead, it can be used to service debt. If such a business has low debt levels, it will become a takeover target.

The second type of LBO, and by far the most spectacular, almost all US in their origins, are the de-merger transaction, the break-up of conglomerates. The business management concept currently in vogue can best be described as a "stick to the knitting" philosophy.

Focus on your core business activities and you will do them really well. Do not spread your management talent over too many fields. CSR is a company which is presently attempting to get back to the knitting. A classic example of the de-merger type

LBO would be the break-up of Beatrice International by the Kohlberg, Kravis & Roberts Group in the United States. Beatrice owned Samsonite luggage, Playtex bras, an orange juice business, confectionary business etc. These businesses have now all been sold off.

The type of risks inherent in these two kinds of transactions are clearly different. In the financial arbitrages, perhaps the key determinant of success is the correct assessment of the appropriate mix of business and financial risk. The higher the business risk, the lower must be the financial risk, and vice versa.

If you were looking at a leveraged buyout of a Coca Cola Bottling Company, for example, you could be very confident that Coca Cola was going to be around in about twenty years time - very low business risk, very predictable cashflow. If you were looking at the leveraged buyout of a small manufacturing company - for example, I was involved in the leveraged buyout of a range hood business called Torin - a better range hood might come along in two or three years time. Such an LBO carries a significantly higher business risk than the Coca Cola Bottling franchise LBO. A significantly higher business risk means you cannot accept the same degree of financial risk. This business risk/financial risk analysis is the responsibility of the LBO specialist. It must be seen in the context that for equity participants in the LBO both the management and the LBO specialist have a need to maximise the leverage inherent in the transaction.

Why? The LBO specialist, because leverage maximises his return on funds invested, and LBO specialists ultimately compete on the basis of the IRR that their investments realise. The manager, because the greater the percentage of the purchase price which can be funded by debt, the greater the percentage of the equity which his personal financial capacity can earn for him.

Being simplistic, if we have a $10,000,000 business and we can finance it with 90 percent debt and 10 percent equity we need $1,000,000 of equity. Management have probably got $500,000 they can put into the deal; they will clearly own half of the business. If you can only put $8,000,000 of debt into the transaction you need $2,000,000 of equity; management has still only got $500,000 - do they get 25 percent of the business or do they get 50 percent of the business? Clearly it is in their interest to have $9,000,000 of debt rather than $8,000,000 of debt.

This necessity for high gearing in LBOs puts the lender in a new ball game. He cannot simplistically apply standard financial ratios to determine whether to make the loan. He too has to develop an understanding of business risks.

Now, the LBO specialist's ability to fund LBOs with the lenders is dependent on the success of his last deal. Failure of a deal will jeopardise relationships built up and nurtured over many years. His incentive to over-gear, therefore, has significant built-in limitations. He is on the same side as the banker, in needing to test management's understanding of their business and their financial projections. He does this by becoming comfortable with the management's predictions about how a business will perform, by spending weeks with them developing the deal and learning about how the business works at the coal face, identifying what the management consultants call its key factors for success.

The banker cannot do this. He has neither the time nor the training. Far more than in conventional corporate lending, therefore, the lender is forced onto character assessments, his judgment of the LBO specialist in particular and management to a lesser extent, in determining whether to do the deal. It is critical to understand that the lender is very dependent on the skills and experience that the LBO specialist brings to the table.

The inescapable conclusion to my mind is that the most useful covenants are the ones which bind the management and the LBO specialist to the deal. They are, therefore, covenants about the control and ownership of the business. Don't let the shareholders sell until the debt is back down to conventional levels, and make sure the LBO specialist is actively involved in the business, post MBO, at board level at minimum.

Turning to the de-merger LBO, the risks are very different. They are stock market related risks as well as business risks. These deals are based on the assumption that bloated corporate overheads can be cut, surplus assets realised, and discrete businesses operated more efficiently and profitably if freed from the restraining hand of head office. As a result, the value of the discrete business units, in aggregate, is greater than the price required to buy the entire conglomerate. The LBO specialist puts together a bid for the conglomerate, and then sells off the parts.

To call on the Beatrice example again, when that transaction was put into effect, I think about 100 people from the head office were fired on day 1, the sponsorship which Beatrice was financing of a grand prix racing car was removed, and on an annualised basis the overheads of the company were cut by $40,000,000. In that transaction I think the price which was paid was a multiple of seven times earnings before interest and tax. So if you cut $40,000,000 off the overhead, in essence you have added approximately $300,000,000 to the value of the business just on day 1. The purchase price of that business by the way was 6 billion dollars, of which I think $300,000,000 was equity - so the equity investors in theory made 100 percent on day 1.

As I said earlier, these de-merger transactions are the most spectacular, and have probably generated the highest returns.

Now, this may come as a surprise, but this is because they carry the highest risks. The principle upon which they are financed in the US is that the deal must be just able to service the associated interest bill for (say) three or four years, with no repayments of principal. The ability to service interest is a function of cash flow, by the way, not just earnings.

For example, if it can be demonstrated to the financiers that working capital could be driven harder and capital expenditure delayed, those savings will be factored into cashflow to determine whether the deal can pay its interest bill for a couple of years. You actually need nerves of steel to do a deal like this. Again to use the Beatrice example, in the first year after the deal was done Beatrice reported operating losses of $70,000,000.

Repayment of principal only starts with divestiture of the businesses. If the stock market falls, so arguably does the value of a privately owned business. The "lending" risks in de-merger transaction therefore have a significant "quasi-equity" component in them.

If, and hopefully when, transactions of this kind develop in Australia, the key issue which lenders and their legal advisors will have to face is the fact that by conventional tests the loans will be in default immediately they are made. So what new tests should be imposed? In my view the key is again to bind the players to the deal, just as in the financial arbitrage type of transaction. It is also important to control all leakages of cash out of the system, in fees and salaries for example. Incidentally, one of the things that always amazes me in looking at the documentation for these transactions from the banks is that they never seek to control fees and salaries. There are always rules and covenants on the payment of dividends but nobody ever asks the question of how much salary is being paid to the managing director. Excess salary payments are just as much cash leakages as a dividend payment.

Finally, there is often a need for complex layering of security levels (senior debt, subordinated debt, preferred equity, common equity) in both the financial arbitrage and the de-merger LBO. The relative rights of the various layers of securities invariably require careful documentation.

NCSC NANNYING

I would like to focus for a minute on one reason why de-merger LBOs have not yet developed in Australia, even though the discredited conglomerate is a much more significant factor on the Australian stock market than the US stock market. One reason that has been put forward is that you probably need to own 100 percent of a company in order to get the debt effectively structured, and for compulsory acquisition in Australia you have to achieve a 90 percent acceptance rate under a takeover offer.

One of the difficulties in achieving the 90 percent acceptance rate is the existence of large number of spoilers - people like Mr Packer, Mr Brierley, Mr Adler - who will enter the stock market, buy 10 percent of the stock and effectively hold you to ransom. I am not sure I agree that this is a key factor. There are probably structural solutions to the problem. We did this a few years ago when I managed the privatisation of Consolidated Press by Kerry Packer. We achieved all we needed to by a 75 percent vote at a general meeting, and compulsory acquisition procedures were redundant.

In fact, I think the main hindrance to the de-merger LBO in Australia is the regulatory structure.

Looking to the US, the quasi-equity for these deals is sourced primarily from the subordinated or high yield junk bond markets. There is no substantive equivalent to this kind of financing in Australia. Byvest has raised a mezzanine fund of $43,000,000 or so, but this is a relatively modest size. The question then is why cannot Australian specialists in LBOs tap into the US market and raise subordinated debt with the likes of Drexel Burnham over there. Exchange risk is partly the issue, but the major reason is cost. The major US LBO specialists finance their public deals on the basis of "highly confident" letters from the major investment banks. Under US takeover rules, such a "highly confident" letter is sufficient proof of interest capacity to let the bidder make his offer. Now a "highly confident" letter is not cheap to obtain, but it is a hell of a lot cheaper than getting a full underwriting, particularly when you start in the absence of certainty that a bid will succeed. Assuming we in Byvest found an appropriate target for a de-merger type LBO on the Australian stock exchange, I have to ask you, do you think the NCSC would allow us, or anyone else for that matter, to announce a bid? The answer has to be "No". The odd thing is that the NCSC rules therefore serve to inhibit our activities. I am just not sure why Australian investors need more protection than US investors.

Do we really need the NCSC to act as a nanny? Why not let the stock market make its own evaluation of a bid's prospects for success? What is the difference between it working out whether Byvest/Drexels will be able to put a financing into place, and deciding whether the Pratt/BTR bid for ACI would need a higher price to go through?

LEVEL PLAYING FIELDS

I will now turn to another aspect of the law which irritates me, although I have to concede that I am not sure whether the problem I am about to describe has its basis in the law or some kind of cultural cringe.

Three weeks ago I was in the US, and heard a speech given by the C.E.O. of Macys. (Macys, I should say, about eighteen months ago did one of the largest leveraged buyouts or management buyouts in US history. It was about a 4 billion dollar deal, I think.) He told us that he had been asked on a number of occasions why they did an MBO. His view was that this was the wrong question. They decided to do the Macys MBO when they could find no reason not to.

I doubt I could find one managing director of a major Australian public company who would address the issue in that way, with a presumption that it should be done in the absence of a compelling reason otherwise. As I said earlier, management must manage their capital structures. The public listing has costs as well as benefits.

While the managing director, with little or no equity in his company, probably fails to address the issue of whether the business would be worth more if privately owned, his major shareholder (if he has one) is probably a little more "hands on" about this. It is probably an endemic issue for him as to whether he should buy out the balance of his subsidiary or associate, as the case may be.

In deciding what to do about this, I wonder what financial and other information is available to this major shareholder in making that decision. I wonder whether, in using that information, this shareholder tells the independent directors on the board of the subsidiary or associate that he is using information about the company, received by him, in his capacity as a director of the company, for such a purpose, or even that he is showing it to his financial advisors and his own directors?

I wonder if the offending major shareholder even knows that he might be breaking the law in doing this?

Now let's look again at our managing director. He's pretty cute - he has heard of Byvest. He might even know Ross Grant, Bill Gurry or myself. Or he might know someone on our supervisory board - Fred Millar, John Dahlsen, or Richard Wiesener, say. He might even think we are reasonably reputable, possibly even "blue chip".

He's also heard about leveraged buyouts in the US. So he has a decision to make - "do I sincerely want to be rich?" If the answer to my question, i.e. why do Australian managers rarely ask themselves "should I do an MBO", is the cultural cringe, that unlike their US counterparts they don't want to become rich, I cannot complain. If, however, the answer is "yes, I do want to do an MBO and become rich", how does our managing director go about working on the deal? He has the same information which his major shareholder has been happily using, but can he use it? He does not want to talk to his controlling shareholder if there is one, because he runs the risk of a career blot. Why should he take this risk before he has any idea, on the basis of talks with an LBO specialist, whether the deal will fly? But if he asks for legal advice on what he can or cannot show to the LBO specialist, bitter experience tells me the answer will be "not much". If he comes to me direct, I also must tell him to seek legal advice before the corporate veil can be lifted. The managing director is in effect in a kind of blind alley, a catch 22 situation. What irritates me particularly is that when I talk to my counterparts in the US, they talk about the overwhelming advantages of management-sponsored bidding groups. I just do not see them here at this point in time.

We at Byvest looked at doing a leveraged buyout with the divisional management of Rheem. The managing director of Rheem was not interested in doing the deal, but the general managers were. However, as a result of the antipathy of the managing director, who since Rheem was taken over has moved onto pastures new anyway, we were unable to achieve the kind of access to the general managers, to get the detailed information which we needed, to develop a proposal. If BHP had been deciding whether to bid for the minorities in Rheem, it would clearly have had access to those managers and that information. I am forced to the conclusion that the rules are different for major shareholders.

These issues are a major problem for lenders as well as LBO specialists. Highly leveraged transactions of this kind can only be put together with detailed information on and knowledge of the business being required. This information has to be disseminated to all the financiers involved. The legal advice which is being given to management is preventing this from happening, while identical "crimes", if that is the right word, are being committed on a daily basis by major shareholders of companies.

Everyone focuses in on the conflicts of interest inherent in management buyouts. I cannot see that conceptually these differ significantly from the conflicts of interests inherent in a bid for a subsidiary or an associate, presuming in both cases that the bidder has access to corporate plans, strategies and management accounts.

What about a level playing field for management? Do we have to change the law? Or has someone got to sue a major shareholder offeror? Or does the advice given by lawyers to management have to be more robust, given that they <u>are commercial lawyers</u>?

Ladies and gentlemen, in the absence of erudition or wit, I have sought to be a little controversial. I hope you will find erudition and entertainment in the debate which I hope this will promote. Thank you.