Having Your Cake and Eating It Too

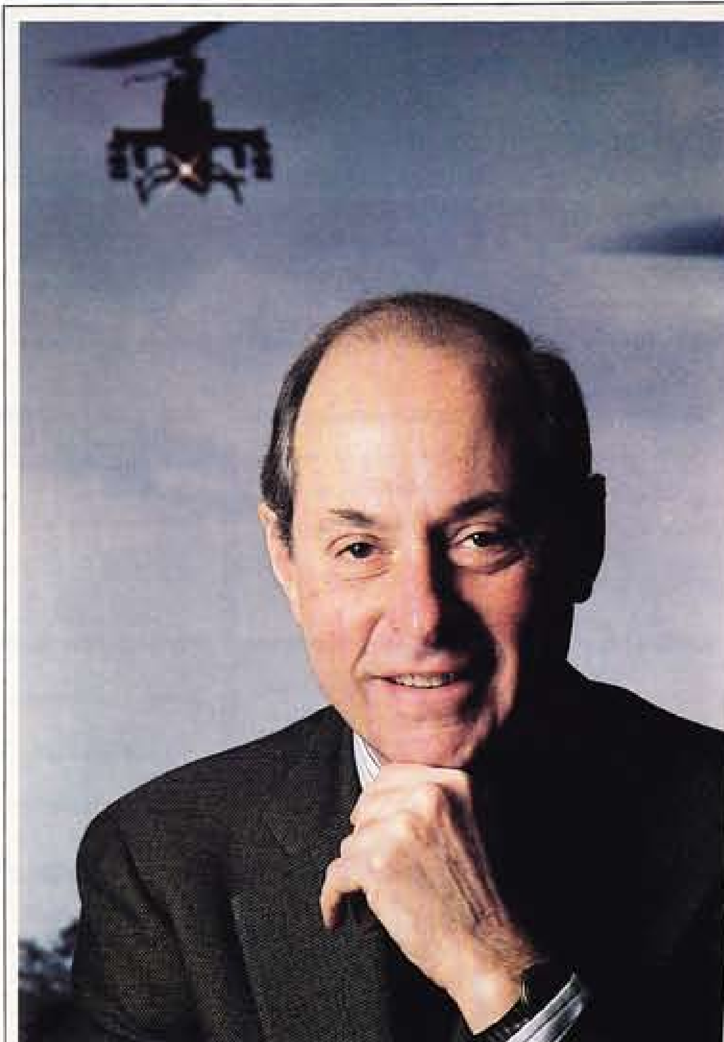
By S. L. MINTZ

Wickes Companies' Sanford Sigoloff launched a hostile raid in early August that threatened to bring halcyon days at Owens-Corning Fiberglas to a rude end. Yet Owens-Corning Chairman William Boeschenstein faced a fate even more humbling than the loss of his job after three straight years of improved earnings and a promising acquisition in the aerospace industry. At stake was no less than control of a company his father helped to start in 1938 and ran until he retired in 1967.

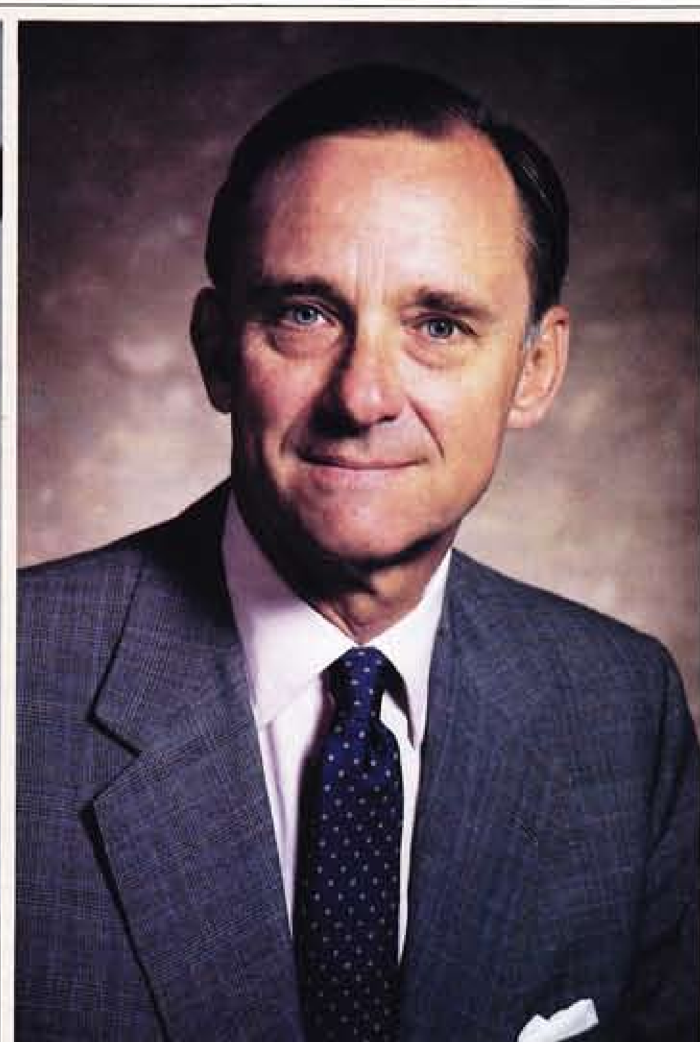
To counter Wickes, Owens-Corning management did not choose to submit a competitive tender offer, nor did it assemble a private buyout scheme. Instead, the Toledo-based manufacturer became the seventh major corporation—the sixth this year—to propose a leveraged buyout with a twist: a public leveraged buyout in which the same shareholder list would continue to own the company even after it assumed significant new debt. Within that shareholder list, however, a dramatic shift in proportional ownership away from public shareholders places a far greater degree of control in the hands of top management and salaried employees.

"This is the most wholesome of leveraged transactions because 100 percent of the fruits of leverage accrue to the shareholders," says Colt Industries Chairman David Margolis. Colt's shareholder leveraged recapitalization plan won approval on September 29, a source of abiding satisfaction to Margolis, who appears to see little difference between turning assets over to a raider or to a handful of leveraged buyout specialists. "When you bring in outsiders," he says, "all the fruits accrue to them." It's a healthy deal for top managers since the resulting combination of debt, disproportionate insider ownership, and some standard antitakeover provisions all but guarantee that no one else will kick them out—even if the recapitalization turns out to be a monumental error.

A more pervasive change in a public company's financial structure is hard to imagine. All existing common shares in Owens-Corning, for example, are to be replaced by shares in the recapitalized Owens-Corning. Public shareholders have been asked to exchange each of their shares for $52 cash, $35 face value of a new issue of junior subordinated discount debentures, and a diluted share of common stock. Four employee benefit funds will shoulder the burden of diluting outside ownership; in lieu of receiving cash or notes for each old share, the funds get 5.6 new ones. Meanwhile, 150 members of management will purchase one million new shares at market value. Outside ownership is reduced by 20 percent.



"Except for more debt, Colt is the same company," says Chairman Margolis.



Owens-Corning's Boeschenstein wants to save the business his father ran.

INSTANT RETREAT

Whatever its long-term merits, the Owens-Corning proposal accomplished its most pressing task. Wickes withdrew its $74 offer, pocketed $30 million when it sold shares back, and beat an instant retreat. That's just the beginning, however. After sales of certain assets and widespread cutbacks reduce debt and operating costs, management expects the company to become more profitable than before. Few chief executives would have shared such sanguine expectations a year ago. Instead they would have paled at the thought of operating a public company with, in Owens-Corning's case, $2.6 billion in total debt added to $2.4 billion in total prerecapitalization assets. But that view of book assets is already considered old-fashioned, replaced by an eye to cash flow and market values.

"Financial strategists contemplating the dark cloud of a hostile takeover have a new way to take themselves off the market without going private."

"If the objective is to have a so-called clean balance sheet, whatever that is, then we're not obtaining it very well," says Robert Malott, chairman and chief executive of FMC Corp. In May, FMC was the first New York Stock Exchange firm to go through a public leveraged buyout. The offer gave public holders of each original share $80 cash and a new share; while insiders received for each original share either 5.667 new ones, or $25 cash and 4.209 new shares. Debt rose six-fold to $2.1 billion, transforming shareholder's equity of $1.139 billion on May 28 into a deficit—the excess of total liabilities over total assets—of $591 million on May 29. Although listed companies are normally expected to show net tangible assets available to common stock in

excess of $8 million, the Exchange has not acted to alter FMC's status.

Malott calls the resulting negative net worth "an accounting aberration," and professes not to worry about it. He insists, instead, that the stock market value of FMC's 46 million shares, around $780 million, is a truer measure of its worth.

"We're running a different company because we have substantially increased debt," Malott says. "But the *modus operandi* is not that different." Nevertheless, he concedes that indebtedness has zoomed to paramount importance. "Obviously, my main concern has to be confidence in our ability to service the debt." With good reason. Interest payments on $1.4 billion in bank loans and $625 million of subordinated debt will eat up nearly 50 percent of projected operating earnings in the first five full years of the recapitalization, through 1991. By any standards, that's very risky.

A look at earnings projections laid out in the offering prospectus begins to show why Malott took a bet on his company. In the five years prior to the recapitalization of FMC, net earnings grew a paltry 6.7 percent, compounded. On modestly increased sales in the first five full years afterwards, compound earnings growth should skyrocket to 24.2 percent. That's the kind of story investors love. As for the chance of disastrous upswings in interest rates, the company has swapped a portion of its floating exposure for somewhat higher fixed rates.

Unlike Owens-Corning, FMC did not opt for a public leveraged buyout under the gun of a clear and present takeover threat. But Malott was well aware that in the previous year a strong cash flow had pushed debt down to a precipitously low level. "We had gotten our debt to equity capitalization ratio down into the low 20s [percent] and they were settling into the low teens," Malott says. "That's not appropriate for the kind of businesses we're in." Whatever the internal implications of low debt and surplus cash flow, Malott was certainly aware that the combination spells opportunity for raiders. Now, he can exercise more direct influence since top management and salaried employees own 40 percent of the company's shares.

Although the initial motivation was different, prospects for Owens-Corning ought to be similar if only because Boeschenstein sits on FMC's board of directors and followed developments there. And like public leveraged buyouts fashioned for Multimedia Corp., Warnaco, Inc., Gulton Industries, and FMC, the principal author was Goldman Sachs.

SELLING "STUBS"

A different group made it possible for Colt Industries to offer $85 cash and a "stub" worth one diluted share to public shareholders, while putting forth a yet-to-be-determined stock split on shares owned by the employees' Retirement Savings Plan. This time, Bankers Trust put together $1 billion in bank financing while Morgan Stanley and Drexel Burnham agreed to underwrite $550 million in subordinated debentures.

For Colt, $1.6 billion in new debt cuts the heart out of shareholder's equity, draining it from $1.3 billion to a negative $1.1 billion. But in the first four full years after completion of the deal, Colt expects compounded earnings to more than quadruple, to 26.4 percent. Consequently, one Colt follower, Douglas Moffat, of Fahnestock & Co., assesses the deal as startling on the surface but less so as you dig underneath and find the cash flow to support it. Even if the stock price doesn't reflect the level of earnings, however, raiders will think twice before going after a company where insider ownership, as a result of the public leveraged buyout, surpasses 30 percent.

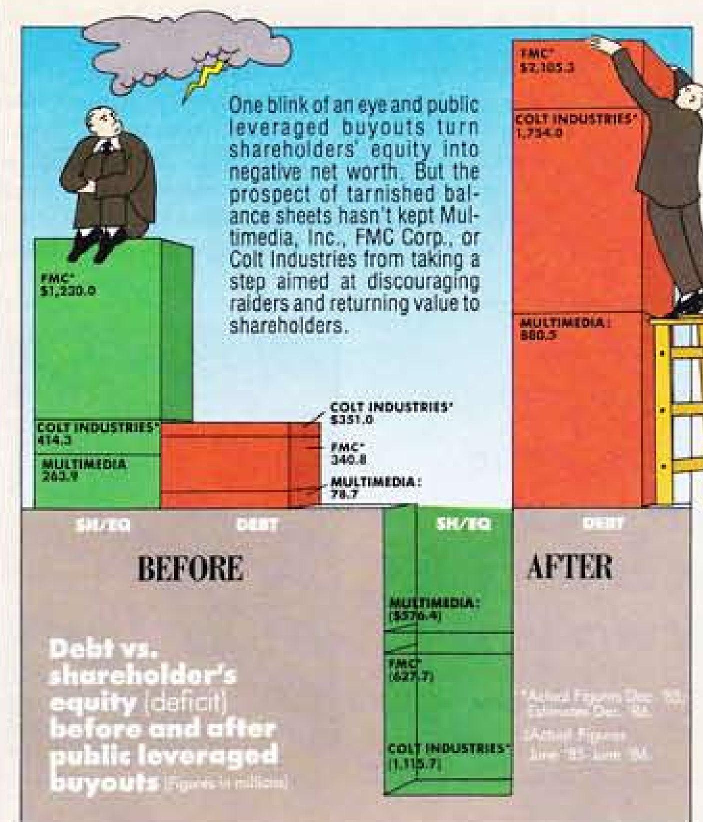
In one essential respect, the Colt deal departs from the others. Instead of an exchange rate fixed in the prospectus, Colt insiders received one share plus a number of shares equal to $85 divided by the median closing sale price of new shares in the first 15 days of the deal. The mechanism was designed to equalize the initial per share values received by public shareholders with those obtained by participants in Colt's Retirement Savings Plan. Although the arrangement appears to leave share distribution in some doubt until the exchange rate is determined, Margolis assured shareholders at a special meeting at the end of September that the board gave careful consideration to the full range of possibilities. "The final number [of shares allotted to the pension fund] hangs in the balance," he said, "but the essence is well understood."

Since public leveraged buyouts, which reshuffle ownership, are fundamentally different from leveraged buyouts, which transfer ownership of the assets, the two are different technically, too. In a public leveraged buyout it isn't necessary to purchase all of the existing shares or pay market value for them. Colt, for example, used 95 percent of the cash it raised to pay public shareholders 83 percent of what it judged the shares were worth; the stub worth one new share of undetermined market value made up the difference. A cash buyout of all shareholders at full market price would have run debt up to $1.9 billion, rather than the $1.6 billion Colt actually took on. It's probable too, notes Carol Neves, a Merrill Lynch securities analyst who follows Colt, that private purchasers would have had to pay an additional premium over the package valued at around $97 to wrest the company's upside potential from its owners. (Suitably enough, old shares closed on October 7 at 96¾; new shares closed the following day at 11¾.)

CHEAPER FOR MANAGEMENT

Thus, in terms of what the world must pay for assets under control of an entrenched management, it's cheaper to let management buy control through a public leverged buyout. That's because the public-at-large only requires a 20 percent return on its investment, whereas professional outside financiers demand from 30 percent to 40 percent, according to Lawrence Lederman, a partner at Wachtell, Lipton, Rosen & Katz, who helped formulate several public leveraged buyouts. Willingness to settle for a lower return stems from the facts that the average investor is hard-pressed these

SHAZAM... ...But magic it's not



The changes illustrated at left became effective overnight, but shareholders will be paying the tab for years. That's why companies can't sell the concept of public leveraged buyouts without first convincing shareholders that future cash flow will be sufficient to cover interest payments. One acid test used to assess debt-paying ability is a *times interest earned ratio* (TIE) that considers depreciation, amortization, and capital expenditures, along with earnings before interest and taxes (EBIT) and interest payments.* Thus,

$$\text{TIE} = \frac{\text{EBIT} + \text{depreciation and amortization} - \text{capital expenditures}}{\text{Interest payments*}}$$

Here's how cash flow coverage of interest payments looked before and after leveraged public buyouts at Multimedia, FMC, and Colt:

	Before Recap	After Recap
Multimedia, Inc.	**8.7:1**	**1.4:1**
FMC Corp.	**3.2:1**	**1:1**
Colt Industries	**16.2:1**	**1.1:1**

*Using net interest or cash interest may cause results to vary.

days to get 10 percent and that publicly traded shares are far more liquid than restricted stock in a private company.

The difference in expected returns is illustrated by the amount investors will pay for a future earnings flow. Public shareholders will pay more for a new share than it is worth to a Kohlberg Kravis Roberts. According to Lederman's thesis, a KKR would pay, at most, $520 million for FMC although the recapitalized company had an initial stock market capitalization of $780 million. In a management buyout the company would have to make up the $260 million difference by adding debt or taking less of an equity cushion, alternatives that become increasingly painful as leverage grows.

By providing the stock market with a self-imposed valuation, public leveraged buyout plans risk exposing a company to the fate it hopes to avoid. That course befell Anderson, Clayton & Co. Its proposed leveraged buyout, with an indicated value of $45 a share, won approval from 80 percent of voting shareholders. Nonetheless, raiders sweetened the offer, and derailed the original plan in court. The Delaware Court of Chancery ruled that the company hadn't lived up to its promise in a newspaper ad to explore avenues of compromise with the group of investors, led by Bear Stearns and Gruss & Co., who began bidding after the recapitalization was announced. By the time a subsequent vote could be taken, says a spokesman for Anderson Clayton, management estimated that the Bear Stearns group and arbitrageurs who jumped in on the deal would have gained the 20 percent share necessary to block the recapitalization. At first, Anderson Clayton responded with a self-tender offer that didn't require shareholder approval. Before it was completed, Ralston Purina stepped in with a bid of $62 and then Quaker Oats cinched the merger at $66.

But in certain situations public leveraged buyouts offer management the quickest way to respond to a takeover threat without sacrificing its independence. "The bonds are placed with existing shareholders so you don't have to search for someone to accept them," says E. Maclin Roby, former chief executive at Gulton Industries. Gulton mustered a public leveraged buyout plan last February in a defense against Mark IV Industries. Even though the plan fell through, owing to the board's uneasiness about heaping debt on shareholders, it succeeded in giving Mark IV competition, a factor that helped push the bid from $30 to $34 a share.

Warnaco, Inc., achieved a similar end with its proposed public leveraged buyout. After an outside group, W Acquisition Corp. (WAC), outbid its original private buyout plan, Warnaco's management offered cash, notes, and a stub for all shares it didn't own already. When WAC raised its offer of $42.50 a share to $46.50, however, Warnaco's board agreed to the merger.

The first public leveraged buyout to incorporate most of the characteristics that have come to define such a deal was consummated in September 1985 at Multimedia. It was prompted when outsiders topped a management buyout proposal that offered shareholders $37 cash and $25 stated value of brand new 15 percent subordinated discount debentures. Despite a competitive face value, the combination of cash and securities fell short of straight cash bids ranging from $60 to $65 a share from such well-heeled adversaries as William Simon of Wesray Capital Corp., Merv Adelson of Lorimar-Telepictures, and Jack Kent Cooke, a private investor who eventually acquired nearly 10 percent of the company. To make matters more complicated, four class-action suits alleged that management was giving shareholders less than what they deserved.

The thought of including the shareholders as the solution to all of these problems occurred at a meeting of the independent Special Committee, formed to assess the proposal, on April 3, 1985. "People came up with this plan that seemed to give everybody what they wanted," says Walter Bartlett, Multimedia's president and CEO. "In essence, we said we're going to give you X dollars of cash, a bond, and a half a share of stock so you can move forward with the new company." In theory it was simple enough. Anyone who saw additional upside potential for the company could retain a share of it. Anyone who thought the deal was fully priced could sell.

The transaction that emerged was a bit more complicated. "Even the arbs, who are extremely sophisticated, gagged the first time they saw it," says Mark Harrnet, an account executive at Multimedia's proxy solicitor, D.F. King. In addition to the diminished share of stock, shareholders were presented with a smorgasbord of cash, subordinated discount redeemable debentures, and rights to purchase fractional shares. Those shares, issued at $10.00, were trading at $43.25 on October 8 despite a shareholder's deficit of approximately $576 million.

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THINKING TWICE

Because of their complexity and risk, public leveraged buyouts are not for everyone. "It's a financial tool that has to be used prudently or it can put a company *in extremis* in a dramatically short period of time," warns a Wall Street investment banker who has been involved in several of the transactions. Ex-Cell-O Corp., for example, never proposed a public leveraged buyout to fend off Textron Inc. although Goldman Sachs, experts in the technique, acted as its adviser in the defense strategy. Ex-Cell-O's balance sheets offer one possible clue why; this is a company unaccustomed to high debt. Shareholder's equity last year was a roomy ten times total debt, versus FMC's 3.3:1 and Colt's scant 1.2:1 ratios.

The financial criteria boil down to unshakable cash flow from a variety of discrete operations, some of which could be sold if things got tight. A narrowly focused high-growth company, for example, is probably not suitable—especially if its stock is already fully priced. In addition, management must have the right disposition for running a highly leveraged company, mainly the willingness to cut costs dispassionately and disregard thoughts of external growth until a sizable chunk of the debt has been paid down. Within weeks of announcing its recapitalization, for example, Owens-Corning dismissed two divisional vice presidents.

As the projections show, paying down the debt will take years. But the impact of public leveraged buyouts on the imaginations of management is apparent. "We've now learned that the public markets can see their way through the thicket of a leveraged transaction and value it properly," says T. Michael Long, a Brown Brothers Harriman partner who worked on the fairness opinion for Multimedia shareholders. In the future it's going to be more difficult, he says, for independent advisers to approve transactions that write shareholders out.

Like so many of Wall Street's innovations of recent years, public leveraged buyouts have not yet stood the test of time, much less the test of a severe recession. Such epithets as "chicken leveraged buyouts" and "junk stock" that critics have raised regarding these deals may be undeserved, but even Goldman Sachs appeared to have doubts about how the deals would be received. It has refused to offer price assurance on new shares, and its placement of debt for Multimedia and FMC was on a "best efforts" basis. How will these deals fare in the long run? Ask Robert Malott. "Put something in your tickler file to come back and talk to me in 1989 or 1990," he says. "Because that's the time when we'll see whether it's been successful or not."

Meanwhile, he still has his job. ■