

Leveraged Recapitalizations and Exchange Offers

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Leveraged Recapitalization is a strategy where a company takes on significant additional debt with the purpose of either paying a large dividend or repurchasing shares. The result is a far more financially leveraged company -- usually in excess of the "optimal" debt capacity. After the large dividend has been paid, the market value of the shares will drop. A share is referred to as a "stub" when a financial recap results in the decline of its price to 25% or less of its previous market value. In a successful recap the value of the dividend plus the value of the stub exceeds the pre-recap share price.

The simplest measure of value added comes from the tax shield gained when a firm, which has debt capacity resulting from free cash flows in excess of ongoing needs, increases its leverage. The classic Modigliani-Miller calculation of the present value of the tax shield is obtained by multiplying the amount of debt by the tax rate of the firm. Other results of leverage include the disciplinary effects of having to meet debt service payments, and the possible negative effects of the costs of financial distress.

The technique can be used, and has been used, as a "shark repellent" to ward off a hostile takeover, actual or potential. This is done by adding debt, eliminating idle cash and debt capacity. Prospective bidders would face the daunting task of returning the firm to leverage ratios closer to historical industry levels. The recap may also give management a higher percentage of share ownership and control. Although such recaps are designed as a takeover defense, a high percentage of firms that adopt them are subsequently acquired. The technique can also be employed proactively, as a means of placing free cash flows into shareholders' hands, and employing debt's disciplinary effect to improve performance, thus increasing shareholder value. A related motivation is giving a founder-owner liquidity.

The market response to announcements of leveraged recaps depends on whether they are defensive or proactive. For defensive recaps, the effects are so varied -- negative as well as positive -- as to make research results inconclusive. On average the effects seem to be positive (Gupta and Rosenthal, 1991). Long run returns in excess of expected for proactive recaps seem to be of the order of 30%, similar to the level in tender offers. (But for a negative view, see "[Debtor's Prison?](#)")

In the case of Sealed Air's leveraged recap (HBS Case 9-294-122), management purposefully and successfully used the leveraged recapitalization as a watershed event, creating a crisis that disrupted the status quo and promoted internal change, which included establishing a new objective, changing compensation systems, and reorganizing manufacturing and capital budgeting processes. This case provides an illustration of how financing decisions affect organizational structure, management decision making, and firm value.

As Sealed Air suggests, the critical feature in both kinds of recaps is whether other operating improvements are made. A key indicator of whether leverage is having the desired disciplinary effect is the post-recap balance sheet progress. When successful, the large overhang of debt service obligations galvanizes management to improve operational performance thus generating sufficient cash flows to pay down the debt.

Exchange Offers involve giving one or more classes of claimholders the option to trade their holdings for a different class of securities of the firm. Typical examples are allowing common shareholders to exchange their shares for bonds or preferred stock, or vice-versa. Exchange offers may have motivations similar to those of leveraged recapitalizations, taking advantage of free cash flows or altering management's share of control, or they may be distress-induced workouts.

Most of us would suppose that nobody would elect to exchange one security for another unless the latter was more valuable than the first, giving the investor a positive return. Yet according to research studies, some types of exchange offers result in negative returns, while others produce positive net returns. The effects seem to depend on whether the exchanges have one or more of the following consequences:

- Leverage increasing or decreasing
- Implied increases or decreases in future operating cash flows
- Implied undervaluation or overvaluation of common stock
- Increase or decrease in management share ownership
- Increase or decrease in management control over cash usage
- Positive or negative signaling effects.

Based on these, one should be able to evaluate the net effect, positive or negative, of the following types of exchange offers:

Right to exchange from:	to:	Net return
Common stock	Debt	+14.0%
Common stock	Preferred stock	+8.2%
Preferred stock	Debt	+2.2%
Preferred stock	Income bonds	+2.2%
Debt	Private equity	-0.9%
Debt	Common stock (forced)	-2.1%
Preferred stock	Common stock	-2.6%
Debt	Preferred stock	-7.7%
Debt	Common stock	-9.9%

Dual-Class Recapitalizations entail the creation of a second class of common stock that has limited voting rights but typically a preferential claim on the company's cash flows, in the form of a higher dividend. For example, the company proposes to create a Class A share with one-share-one-vote, and Class B with 5 votes per share. Class A shares carry a higher dividend rate than Class B, perhaps double. As a result of a DCR, officers and directors will usually end up with 55 to 65 percent of common stock voting rights. In a high percentage of dual-class firms, the control group represents founding families or their descendants. In most cases the firm creates the new class by distributing limited voting shares pro rata to current shareholders. These shareholders can then, if they choose, sell the limited-right shares to the public, thus securing liquidity without sacrificing control -- a motivation typical of closely held businesses in transition.

Case Study

The Leveraged Recap Of Sealed Air Corp.

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The Leveraged Recapitalization

Less than a year after Sealed Air embarked on a program to improve manufacturing efficiency and product quality, the company borrowed almost 90% of the market value of its common stock and paid it out as a special dividend to shareholders. Management purposefully and successfully used the leveraged recapitalization as a watershed event, creating a crisis that disrupted the status quo and promoted internal change, which included establishing a new objective, changing compensation systems, and reorganizing manufacturing and capital budgeting processes. This decision provides a context in which to explore how financing decisions affect organizational structure, management decision making, and firm value. It gives one an opportunity to analyze the concept of free cash flow, its effect on stock market prices and firm value, and the disciplinary role of high leverage.

In 1989 the company's stock price seemed depressed -- at best, it was going nowhere. Yet Sealed Air's business threw off a lot of cash. Prior to the recap the company had over \$50 million in cash and short-term investments and Dermot Dunphy, CEO, expected cash on hand to more than double over the next year and a half. Bruce Cruickshank described the company's situation, stating "there were no good acquisitions and we had nothing to do with the cash. Just increasing the dividend over the years was admitting defeat. We didn't want to be a public utility."

One reason that Sealed Air's stock was "undervalued" was because the company was generating "free cash flow". Free cash flow in excess of that required to fund all the company's positive net present value investment opportunities tempts companies to waste money. Pete Funkhouser, Senior Vice President, described

this problem at Sealed Air, "We didn't need to manufacture efficiently, and we didn't need to worry about cash. At Sealed Air, capital tended to have limited value attached to it - cash was perceived as being free and abundant." For some companies, the most productive use of free cash flow is to distribute it to shareholders and allow them to reinvest or spend it as they choose. The market applied a discount to Sealed Air's stock because managers could not make a believable promise to disgorge the cash. Paying out today's cash balance (\$54 million) would not solve the problem. Borrowing and paying the proceeds to shareholders served to reinforce management's promise not to retain *future* excess cash.

Sealed Air's management faced many alternative uses for the company's cash. Among them were launching a capital expenditure program, buying another company, increasing the regular dividend, or starting to manage a portfolio of securities. One could argue that the decision to recapitalize demonstrates a failure on the part of the top management team; they should have been able to find something productive to do with the money.

In fact, Dunphy felt strongly that his job was not to be a portfolio manager, nor did he want to waste shareholders' money on a second-rate acquisition. He decided not only to pay out the cash on hand, but to borrow against the company's future cash flows and pay the \$40 special dividend. Dunphy felt the market was "substantially undervaluing" the company's stock and seriously considered paying out \$45 - almost the entire stock price - to demonstrate that there was excess value to be realized. Future cash flows would be committed to lenders who had a legally enforceable claim on a specified cash flow stream.

Financing the Transaction

Many shareholders felt this leverage would make the company riskier. Moreover, the banks had a negative reaction. First, management, as shareholders, would receive a substantial payout. Second, the company would end up with negative net worth. Many banks could not get a deal with negative net worth past the loan committee.

Despite these problems, Sealed Air managed to finance the special dividend. Banker's Trust led a syndicate that loaned 137 under a senior secured bank credit agreement. The loan imposed some stringent constraints on the company, including severe limitations on capital expenditures. The company also issued \$170 million in subordinated bridge notes which were later refinanced with a public offering of senior subordinated notes. The remainder of the \$340 million came from cash.

The Result

Following the announcement of the dividend, the company's share price rose briefly -- then, after the share went ex-dividend, it fell to \$12. After that, it rose steadily -- to \$20 by the end of the year, and much higher in following years, as the company

gradually brought its debt down to a more standard level.

Looking back, Dunphy reviewed the result. "There is no doubt that we executed a successful financial transaction. The danger is that it is only that - a financial transaction."

[For more details see **Sealed Air Corp.'s Leveraged Recapitalization (A)** (HBS 9-294-122).]

Questions:

1. Why did Sealed Air undertake a leverage recapitalization? Do you think that it was a good idea? For whom?
2. Dunphy was an MBA (HBS class of '56). Shouldn't any self-respecting MBA be able to find a way to spend several hundred million dollars, and earn a rate of return higher than what shareholders could earn?
3. How much value was created? Where did it come from?

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