

## Hospitality Review

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Volume 3

Issue 2 *Hospitality Review* Volume 3/Issue 2

Article 2

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1-1-1985

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### Recommended Citation

Moncarz, Elisa S. (1985) "Leveraged Buyouts: Opportunities and Risks," *Hospitality Review*: Vol. 3: Iss. 2, Article 2.

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# Leveraged Buyouts: Opportunities and Risks

## **Abstract**

This article presents a general overview of leveraged buyouts, relating their feasibility as an option for hospitality management. Specifically, the author explores the background and main features of leveraged buyouts, focusing attention on their risks and rewards, management's opportunities, tax ramifications, planning, and future outlook. Denny's leveraged buyout is examined in order to provide an insight into the structuring of a buyout for a major food service firm.

## **Keywords**

Elisa S. Moncarz, Leveraged Buyouts: Opportunities and Risks, LBO's, Debt, Financing, Public/Private, Denny's, FIU

# Leveraged Buyouts: Opportunities and Risks

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*This article presents a general overview of leveraged buyouts, relating their feasibility as an option for hospitality management. Specifically, the author explores the background and main features of leveraged buyouts, focusing attention on their risks and rewards, management's opportunities, tax ramifications, planning, and future outlook. Denny's leveraged buyout is examined in order to provide an insight into the structuring of a buyout for a major food service firm.*

Leveraged buyouts have received increased attention as a business strategy in the past few years. They have become "one of the most successful and certainly most creative ways to purchase corporate assets,"<sup>1</sup> and have been described by some observers as the corporate trend of the '80s, providing a unique opportunity for management to own and operate a business.

Although the hospitality industry has not actively participated in the leveraged buyout boom, the recent execution of the buyouts of Denny's, Inc. and ARA Services, Inc. leads to speculation on the likelihood that leveraged buyouts might become a trend in the hospitality industry. Surely, "the Denny's deal is the first big test of whether the restaurant industry can participate successfully in leveraged buyouts."<sup>2</sup> A leveraged buyout (LBO), also called management buyout, occurs when a private consortium of management, investment bankers, and institutional investors borrows money to purchase a company from public shareholders or from a parent company. "By using mainly borrowed funds and putting a little of their own equity, managers are entering the world of entrepreneurship."<sup>3</sup> In a LBO the investor group that includes the management of the company to be acquired takes the company private in a transaction largely financed by borrowings. Ultimately, the debt is repaid with funds generated by the acquired company's operations or the sale of assets.

"A well conceived, planned and executed leveraged buyout can give an opportunity for significant capital appreciation in a relatively short period of time."<sup>4</sup> When it works, it pays off handsomely for all concerned. While entrepreneurial executives obtain a chance to own a company, stockholders are paid a premium for their shares, and deal organizers get fees and a share of profits.

As previously noted, LBOs are heavily financed with debt. Financial institutions and other outside sources typically provide between 70 and 90 percent of the purchase price. Equity contributions are normally kept low to achieve the greater upside appreciation and return on investment. "The net effect is that debt is used to retire equity, which is known as leveraging up a company's capitalization."<sup>5</sup> "It is not unusual for the debt to equity ratio of a company to be more than 10 to 1 after a LBO."<sup>6</sup> A leveraged takeover (or institutional buyout) is distinguished from a leveraged buyout in that in a takeover the company is acquired by a group of professional investors who are outsiders, whereas in a leveraged buyout certain members of management acquire the company, division, or subsidiary they are currently managing.

### **LBOs Are Not New Phenomenon**

Although LBOs have been receiving a considerable amount of attention lately, the leveraged buyout concept has been around for over 20 years when it was known as "bootstrapping;" General Electric Credit Corporation has been a main purveyor of financing for LBOs for the past 20 years, and has thus been regarded as a pioneer in this area. Prudential Insurance Company has also been involved in LBOs since the early '60s.

Opportunities became abundantly apparent for LBOs in the latter half of the '60s when the conglomerates found themselves flooded with acquisitions. Often they wished to sell pieces of the larger companies they acquired in order to improve group, divisional, or company structures. The first investment banking firm to take notice of the potential rewards of LBOs was Gibsons, Green and Rice. In 1976, Kohlberg, Kravis, Roberts and Company was formed and became "the undisputed leader in the field"<sup>7</sup> of LBO specialists. Until 1979 most of the LBO deals were valued at less than \$100,000 and thus were too small to be of interest to large investment banking firms. By 1982, however, the total LBO deals amounted to \$2.4 billion, accounting for 13 percent of all corporate divestitures. As a result, many investment banks began to notice the LBO boom and opened separate departments dedicated to providing assistance and planning for LBOs.

Over the past few years, "a vigorous economic recovery, combined with relatively low interest and inflation rates and increasing corporate cash flow and liquidity, has encouraged a rising tide of leveraged buy-outs."<sup>8</sup> In the period from January 1 to October 12, 1984, there were 62 LBOs amounting to \$13.5 billion, compared to 30 LBOs amounting to \$6 billion in the same period in 1983, according to Securities Data.

### **Buyouts Require The Restructuring Of Corporate Ownership**

A major feature of a LBO is that the equity capital (ownership) is shared between the managers and the outside investors who help finance the acquisition of publicly-held stock. The great appeal to the investor-manager is that he or she changes from an employee to an entrepreneur.

Typically, an investment firm engineers the deal by putting together

the buying group, which is comprised of outside investors and certain members of the company's management. The investor group is interested in purchasing the company with little equity and a great deal of debt, secured by the company's assets. The idea is to complete the buyout with funds raised from pledging or selling existing assets of the purchased company.

Banks financing for an LBO is often complex and many-faceted. Banks and insurance companies provide the bulk of the required debt financing. They generally require assets such as property and equipment, inventories, or receivables as collateral for their loans. Due to the risk factor, loans are offered in significant excess over prime rate, often through bridge financing and remortgaging. Other financing sources include small business investment companies, venture capitalists, federal and state government agencies, and employee stock ownership plans. Also, pension funds have provided a considerable amount of equity capital for buyout deals.

Immediately after the buyout is completed, there is a restructuring of corporate ownership by replacing the entire public stock interest with full equity ownership by the private investor group. Managers will generally share subsequent equity ownership with outside private investors who helped finance the LBO.

The return to private ownership (going private) "potentially yields material reductions in registrations, listing, and other stockholder servicing costs."<sup>9</sup> Private companies have more freedom in their decision-making process. "Business decisions are addressed solely from their economic viewpoint without regard to the potential impact on earnings per share."<sup>10</sup> Implicit in this argument is that once private, the company can manage its business in its best long-term interests rather than on the short-run orientation of the stock market. That is, without public shareholders, managers are able to concentrate more on long-term goals.

Frequently LBOs are structured as mergers. In that event, the public firm is usually combined with a shell corporation created expressly for the purpose of going private. "Under the merger agreement the stockholders of the shell corporation (the incumbent management group) become the sole equity owners of the surviving firm. The public stockholders must surrender their shares and receive cash in return. Stockholders of the public firm must vote to approve the merger."<sup>11</sup> If the buyout turns out to be a successful venture, the company can retire the debt within five to 10 years. The investor group can then realize large returns by reselling the company. In many instances, "the company goes public again, sometimes scoring a second success in the new issues market."<sup>12</sup> It is not unreasonable to expect annual returns of 40 or 50 percent. In extraordinary cases, larger returns have been achieved.

**Prime Ingredients For Successful LBOs**

LBOs are not suitable for all types of companies. Promising candidates for LBOs among hospitality firms will share many of the following characteristics:

Strong and competent management team expected to stay once the transaction is completed. Essentially, continuity of management has been regarded as a basic ingredient for a successful LBO. High cash generators, thereby facilitating the repayment of the new debt.

- Limited outstanding debt which permits the addition of significant additional borrowings.
- Undervalued assets which also allow the payment of a premium to selling shareholders and a purchase at a reasonable price.
- Stable earnings growth. Although the company does not need to be highly profitable, it must have some fundamental strength to build on so that competent management will be able to comfortably service the debt.

It is crucial to maintain earnings at projected levels during the period of time that it will take to bring the debt ratio to a more manageable position. Ideal candidates for LBOs are undervalued companies that have low debt, large and steady cash flows, and prospects for stable earnings growth.

The key in identifying potential opportunities for LBOs in the hospitality industry requires a full appreciation of the reasons why a company or division is being sold or divested. The main circumstances in which LBOs arise are:

- Public companies that are trading at prices below their net asset values. Management-investors take the company private in a LBO. Indeed, the most difficult LBO is taking a public company private because of the shareholders' concern for receiving a fair price.
- Divestitures of divisions that no longer fit the corporate strategies of the public companies that own them. Management wants to divest resources by spinning off unwanted divisions.
- Private companies in which the owner is near retirement (or perhaps intends to pursue other interests).
- Situations in which there is a threat of hostile takeover attempts.
- Instances in which the board of directors might be frustrated with dissident shareholders.

### LBOs Have Tax Advantages

A favored aspect of LBOs is their current tax treatment. Actually, "Uncle Sam has subsidized the leveraged buyout business"<sup>13</sup> through liberalized depreciation rules included in the tax code. Most LBOs pay little or no income taxes in the first few years after conversion as a result of the increased depreciation charges based on the higher book value of the assets written up. Also, the interest on the borrowed money, in contrast to dividends, is tax deductible and thus shelters earnings.

Since private companies are not required to report earnings for public

shareholders, they can make the fullest use of the liberalized depreciation deductions included in the Economic Recovery Tax Act of 1981, as recently amended. The augmented cash flow derived from the tax savings can then be used to service and retire the large debt incurred during the buyout.

A recent provision of the Tax Reform Act of 1984 (TRA) provides an added tax incentive affecting LBOs. According to TRA, "banks and other commercial lenders will be able to exclude from taxable income 50 percent of the income received on loans to Employees Stock Options Plans (ESOP)."<sup>14</sup> These lenders are expected to pass on some of these tax savings to the ESOP, thereby encouraging a new form of LBO by making these plans an inexpensive way to finance the buyout.

### **Management Opportunities Exist**

LBOs provide a unique opportunity for talented managers to own and operate the business they are currently managing. Experts have indicated that this opportunity might result in "the revitalization of the chief executive by becoming a mature entrepreneur"<sup>15</sup> as entrepreneurs often take a different view of the world of professional managers. They have stronger beliefs in property rights and in managing for the long term. "Entrepreneurial managers can make small units grow more rapidly and take advantages of market niches."<sup>16</sup> The whole emphasis is on management involvement and motivation since owner-managers stand to benefit more. They become more committed, deriving increased productivity for the company. Experience also indicates that buyouts enable managers to be compensated in ways that would be quite difficult to carry out in a publicly-owned company. The likelihood of receiving "bonus plans that give managers as much as 100 percent of company profits above some target profit figure may also yield strong productivity gains for some companies."<sup>17</sup>

Moreover, productivity gains can also be achieved because "LBOs replace passive public investors with sophisticated institutional investors who have strong financial interest in the future profitability of the company."<sup>18</sup> These institutional investors will normally monitor the operation of the private company following the buyout through representation on the board of directors.

### **LBOs Do Have Risks**

LBOs have been very attractive for all parties involved as a result of the prospects for spectacular returns. For investors putting equity money into buyouts, returns on investments of over 40 percent have not been uncommon. While allowing corporate managers to become corporate owners, selling shareholders usually receive a generous premium above the current market value of their stock. At the same time, deal organizers receive hefty fees and a percentage of profits. Buyouts have also helped some corporations shed unwanted divisions for premium prices.

Still, despite the potential for impressive returns, LBOs involve substantial risk. Once the LBO is completed, the company is deep in debt. "The greater the leverage, the greater the risks to the company, its shareholders, and creditors."<sup>19</sup> The risk is further magnified "when

debt is short-term and tied to prime rate fluctuations as is much of the debt provided in LBO situations.<sup>20</sup> Two unknowns can jeopardize the company's existence: an economy downturn and a significant rise in interest rates. "A movement of 3 to 4 points in the prime rate or a credit squeeze may be enough to place the future of a marginal LBO in jeopardy."<sup>21</sup> Recently, government officials have expressed concern about the undue risks of LBOs by voicing their warnings and questioning their wisdom. Paul A. Volcker, chairman of the Federal Reserve Bank, warned in June 1984 that "LBO transactions could give the acquired company excessive debt," placing too heavy a demand on cash flows. Similarly, SEC chairman John Shad warned "the more leveraged takeovers and buyouts today, the more bankruptcies tomorrow." Once a company has balanced the rewards and risks associated with LBOs and decided to follow the LBO route, certain steps need to be implemented in planning a successful plan of action:

- Perform sufficient modeling of alternative interest rates and business conditions in order to evaluate the chances of success.
  - Analyze accounting and tax consequences.
  - Exercise extreme caution in the selection of professionals, which should include:
    - **lawyers:** They will play a key role in structuring acquisition and debt agreements and in the negotiating process.
    - **accountants:** They will provide tax advice and will assist in the preparation and analysis of financial statements.
    - **investment bankers:** Those experienced in LBOs will provide advice and assistance in obtaining financing.
    - **appraisers:** They will assist in the determination of the collateral value of property and equipment.
- The main objective to keep in mind is to structure a financing package that not only enables the buyout, but also permits adequate cash flow to fund current and future operating needs.

### Future Outlook For LBOs

Despite the recent LBO boom, it appears that LBOs have cooled down a bit after reaching a peak in 1984. Lenders and investors have become more wary of buyouts, making it more difficult to raise money and line up investors. Also, many LBOs have become overpriced; hence the economies of these deals might no longer be acceptable for investors. LBOs have been subject to criticism from government officials and others about their undue risks as well as management's gains coming at the expense of public shareholders. This latter contention was disproved by a recent study conducted by Harry deAngelo, Linda deAngelo, and Edward Rice, which concluded that buyouts are rather beneficial to public shareholders. The study revealed that in a typical situation, the public shareholders' offer "involved a price that was 56



percent above the market value prior to the initial offer."<sup>22</sup> Another issue that might affect the future environment for LBOs is the role that buyouts are expected to play as a defensive maneuver to halt an all-time high hostile takeover trend. To this end, "there are definite signs that LBOs may soon form the arsenal of standard defense measures that have been dreamed by investment banks to replace untriedly bidders,"<sup>23</sup> better known as corporate raiders. Future trends are clearly toward the continuation of LBOs as long as the potential for substantial wealth remains a strong incentive for all participants. The tax system is also expected to preserve the favored treatment of LBOs, encouraging their future growth. Further, conglomerates are divesting themselves of unwanted units, "offering them to their managers as part of the unwinding of the merger and acquisition craze of the past decade."<sup>24</sup> This provides a unique opportunity for the hospitality industry since some conglomerates are currently re-evaluating their commitments to food service chains and some have publicly announced their plans to sell their food service divisions.

### **Denny's, Inc. Has Buyout**

Denny's, Inc. has been engaged in the food service business primarily through the development, management, and operation of full-service restaurants (coffee-shop division), donut houses (Winchell's division), and quick service, Mexican-style, char-broiled chicken restaurants (El Pollo Loco division). Denny's sales volume had placed it in first place in the coffee shop and family restaurant segment, significantly ahead of other competitors.

On January 24, 1985, Denny's shareholders approved an LBO offer of \$43 a share (or about \$734.2 million) at a special meeting of shareholders in La Mirada, California, "a transaction that is of a magnitude unprecedented in the food service industry."<sup>25</sup> Originally proposed by Merrill Lynch Capital Markets (Merrill Lynch)<sup>26</sup> in May 1984 after being consulted by Denny's on the feasibility of disposing of its Winchell's Donut Houses division,<sup>27</sup> the Denny's LBO was expected to be finalized in three to five months. However, the private investor group led by Merrill Lynch was unable to line up all the required financing to support the original offer of \$45 a share, delaying the consummation of the buyout until January 1985. At the same time, "the price to be paid to Denny's shareholders was cut to \$43 a share from \$45 a share,"<sup>28</sup> resulting in a reduction in the value of the LBO deal to \$734.2 million from \$787 million.

The Denny's buyout was structured as a merger in which a wholly-owned subsidiary of a Delaware-based holding company named DHI<sup>29</sup> merged into Denny's. "As a result of the merger, Denny's would become a wholly owned subsidiary of the new privately held company — DHI, principally owned by certain members of Denny's management, by Merrill Lynch, and by other financial institutions," according to proxy material sent to Denny's shareholders in advance of the special meeting of January 24, 1985, to vote on the proposal.

The private investor group was comprised of 55 members of Denny's senior management led by its president and chief executive officer Vern

O. Curtis and by Merrill Lynch and affiliated investors. The 55 members of Denny's management team who participated in the LBO "acquired 18 percent of Denny's by combining \$6.6 million from tax free swaps of stock options and cashing in accumulated performance bonuses"<sup>30</sup> when in fact their own cash investment was only \$1.5 million. "Although management's \$8.1 million investment accounted for 18 percent of the company's common stock, it represented \$132 million of the \$734.2 million value of the transaction,"<sup>31</sup> a potential for a sizeable return on investment should the company go public at some point in the future.

Individually, Vern O. Curtis became the biggest management shareholder with a 3 percent stake in the company after an investment of \$1.2 million. On May 25, 1984, the last full day of trading prior to public announcement of the proposed LBO, "the reported closing price on the New York Exchange (NYSE) composite tape was \$32 5/8 per share of Denny's common stock."<sup>32</sup> On September 25, 1984, the last full day of trading prior to public announcement of the decline of the original offer price to \$43 a share, "the reported closing price on the NYSE composite tape was \$38 per share of Denny's common stock."<sup>33</sup> On December 21, 1984, the day the proxy statement was mailed to shareholders to vote on the merger, "the reported closing price on the NYSE composite tape was \$41 3/4 per share of Denny's common stock."<sup>34</sup>

### **Denny's Was Well-Suited For Buyout**

Denny's was considered to be well-suited for a buyout among restaurant companies because "it had more than \$100 million in cash and generated strong cash flows needed to pay off the debt that is the result of the buyout."<sup>35</sup> Besides, Denny's was a conservative company among food service concerns with an attractive record of quality and consistency in earnings.

Denny's was an extremely well-managed operation, which had experienced tremendous expansion and increased profitability over the past several years. Analysts perceived Denny's management team as one of the most competent and respected in the restaurant industry. Its operational and financial controls were considered among the best. Denny's was very strong financially. Its debt as a percentage of total assets was a reasonable 55 percent and it was a highly liquid firm. The book value per share of Denny's common stock was \$19.44 on June 29, 1984, which was seen as an indication of undervalued assets. A special committee of Denny's board of directors that evaluated the fairness of the \$43 per share price paid to Denny's selling shareholders indicated that the aforementioned price provided these shareholders with an opportunity to receive cash for current investment at a higher rate of return than Denny's historical dividend yields.

Obviously, the most significant amount of funds required to finance the buyout came from borrowings, and thus reflected a major increase to Denny's debt load of \$568.2 million. (See Exhibit 1). The main portion of debt financing was supplied by Morgan Guaranty of New York and Wells Fargo Bank, providing \$372.6 million at one point over prime rate and \$118.7 million at 2.5 points over prime rate (as defined) in

the form of revolving credit loans and subordinated floating rate notes due at various times through 1997. In addition, Prudential Insurance Company provided \$60.5 million at 15.5 percent and \$16.4 million at 16.75 percent for senior and subordinated fixed rate notes. The balance of the capital needed to finance the Denny's LBO was received from the investor group led by Merrill Lynch and from Denny's accumulated cash balances. For its part, the consortium led by Merrill Lynch invested in \$35.6 million of preferred stock paying 13 percent dividends and purchased 77 percent of the \$44.4 million common stock outstanding. Denny's profit sharing plan also invested in 5 percent of the common stock outstanding.

A breakdown of the ownership interest (common stock investment) with respect to Denny's LBO transaction follows:

### Exhibit 1

#### Denny's Leveraged Buyout: Sources and Uses of Funds In Millions of Dollars

<b>Sources of funds</b>	
Debt Financing:	
Revolving credit loans	\$372.6
15.5% senior fixed rate notes	60.5
Subordinated floating rate loans	118.7
16.75% subordinated fixed rate notes	16.4
Total debt financing	<u>568.2</u>
Equity Financing:	
DHI redeemable preferred stock	35.6
DHI common stock	44.4
Total equity	<u>80.0</u>
Denny's existing cash balances	104.0
Total sources	<u>\$752.2</u>
<b>Uses of funds</b>	
Payment to Denny's shareholders (\$43 a share)	734.2
Payment of fees and expenses incurred in connection with the merger	18.0
Total uses	<u>\$752.2</u>

**NOTE:** All the outstanding capital stock of Denny's and substantially of its wholly-owned subsidiaries were pledged to secure the payment of the principal and interest relating to the debt portion of the financing.

**SOURCE:** Denny's Proxy Statement, December 21, 1984.

A breakdown of the investments is as follows:

Amount in Percent  
millions of dollars

Denny's management group	\$ 8.1	18.2%
Merrill Lynch consortium	34.1	76.8
Profit sharing plan	2.2	5.0
	\$44.4	100.0%

LBOs involve enormous risk for all involved, and Denny's appears to be no exception. Denny's buyers added over \$560 million of debt to the company's capitalization, which resulted in raising the debt burden to about \$792.5 million. Since the buyout also decreased the equity base to about \$44 million from \$312 million, Denny's debt to equity ratio was raised from less than 1 to 1 to the excessive level of 18 to 1 (see Exhibit 2).

### Exhibit 2

#### Denny's Leveraged Buyout Impact on Capitalization In Millions of Dollars

	Denny's 9/28/84 <sup>1</sup>	Denny's LBO 9/28/84 <sup>2</sup>
Long-term debt <sup>3</sup>	\$ 92.3	\$ 92.3
Long-term notes	47.9	—
Convertible debentures <sup>4</sup>	132.0	132.0
Obligations under capital leases		
Revolving credit loans		
Senior Fixed Rate Notes		372.6
Subordinated Floating Rate Loans		60.5
Subordinated Fixed Rate Notes		118.7
Total Long-term debt	272.2	792.5
Preferred Stock		35.6
Common Shareholders' Equity	312.2	44.4
Total Capitalization	\$584.4	\$872.5
Debt to equity ratio	.87 to 1	18 to 1

- The quarter ending September 28, 1984, was Denny's last full reporting period before it went private.
- Proforma capitalization figures give effect to the execution of the leverage buyout pursuant to the terms of merger and financing. They also give effect to the sale of the rights to Denny's trademark in Japan to Denny's Japan Ltd.
- The consolidated long-term debt of Denny's includes current maturities of \$10,596,000.
- Denny's called for redemption on Jan. 24, 1985, of all of its outstanding 9 1/2% convertible subordinated debentures due October 15, 2007, at a redemption price of 107.77% of the principal amount thereof plus accrued interest.

SOURCE: Denny's, Inc., Proxy Statement, December 21, 1984.

“Denny’s entered into interest rate swap arrangements to mitigate the impact on Denny’s of increases in borrowing costs resulting from fluctuations in interest rates.”<sup>36</sup> Nonetheless, interest payments for 1985 are expected to “exceed \$72 million and every one-point rise in interest rates could cost the company \$5 million.”<sup>37</sup> Denny’s net income for the fiscal year ending June 30, 1984, was \$45 million on revenue of \$1.2 billion. As a result of the buyout, however, interest expenses on the massive debt would almost eradicate any prospects for increased earnings and had been expected to retard Denny’s aggressive expansion program in 1985. (“Denny’s 1984 strategic plan without given recognition to the LBO estimated the 1985 revenue to be \$1.45 billion with net income estimated at \$54 million.”)<sup>38</sup>

It is evident that the investor group that acquired Denny’s on a LBO — not to mention the three primary lenders — stands to incur substantial losses if Denny’s LBO does not prove successful. It should be noted, however, that it is the belief of many analysts that if everything goes as planned, profits could pay off most of the principal and interest within 10 years. In such a case, should the company become highly profitable again, the resale of Denny’s to the public would result in dramatic returns to the participating management, investors, and Merrill Lynch. Thus, high stakes are involved in Denny’s LBO. Still, if the buyout works according to company’s expectations, it might prove to be extremely rewarding for all concerned.

### Denny’s Post-LBO Strategy

Analysts had predicted that Denny’s would slow its past torrid expansion pace in the aftermath of the LBO to “direct cash flow toward accelerated debt service.”<sup>39</sup> Nonetheless, confronted with the prospects that slower expansion could lead to loss of its coffee shop market dominance, Denny’s has “decided to launch a selective program of restaurant franchising,”<sup>40</sup> thus reversing a company trend that began in 1970 which was adverse to the use of franchising as a method of expansion. By doing so, potential initial franchise fees and continuing sales royalties could help to service the huge debt resulting from the buyout. Meanwhile, with the advent of the franchising program, the faster growth rate is likely to continue in spite of the LBO.

Some observers have also pointed out that Denny’s 1983 acquisition of El Pollo Loco division provided “a growth vehicle that may be brought public on its own, creating an exciting public vehicle if deemed desirable.”<sup>41</sup> But Denny’s original “vision for El Pollo Loco becoming America’s pollo chain,”<sup>42</sup> which accounted for its building up the chain to more than 35 units in California and Texas, may have to be reconsidered. The buyout “has placed enough of a financial strain on the company to raise questions whether it can afford to keep rapidly expanding El Pollo Loco and whether that would divert critical financing resources from Denny’s restaurants themselves — still Denny’s main growth vehicle.”<sup>43</sup>

## Other LBOs Exist in the Industry

In addition to Denny's LBO there have been other buyouts floating in the hospitality industry over the past year or so. ARA Services, Inc., a Philadelphia-based contract feeder, thrilled shareholders when 70 top executives took the company private in December 1984 in a LBO deal valued at \$882.5 million. ARA's selling shareholders received \$71.75 a share, "a windfall considering ARA's price before takeover talk began earlier in 1984 was in the mid-\$40's."<sup>44</sup> As a consequence, the members of management who participated in the LBO attained "31 percent ownership of the company, putting up 2 percent of the capital and borrowing the rest against ARA's assets."<sup>45</sup> Recent reports indicate that ARA's pretax operating earnings for the quarter ending March 31, 1985 (the first reporting period as a private company), "rose slightly from \$39.7 million in the same period of the previous year."<sup>46</sup> Yet "net after-tax profits dropped considerably compared with the \$16.2 million of the last year's similar quarter,"<sup>47</sup> reflecting the substantial interest that ARA was paying on the buyout debt.

Conversely, a \$525 million LBO plan to buy Chicago-based Diversifoods, Inc., operators of the Godfather's Pizze chain and franchised Burger Kings, was abandoned in 1984. Diversifoods' former chief executive officer Don Smith and other top executives attempted to take the company private in a LBO transaction, but they dropped the offer after failing to secure financing in the wake of steadily declining earnings. This resulted in the forced resignation of Don Smith as head of Diversifoods.

As part of a refocusing trend among conglomerates (especially grocery product companies), "Ralston Purina signed an agreement to sell its Foodmaker restaurant subsidiary (operators of Jack-in-the-Box) for \$500 million to a management group led by Foodmaker's president and chief executive officer Jack Goodall in a LBO transaction."<sup>48</sup> However, the LBO plan fell through because the leaders refused to support it due to Foodmaker's declining earnings and unfavorable economic conditions in the industry. Another conglomerate that is presently planning to sell a number of its restaurant chains is General Mills.

Reports had also surfaced that Howard Johnson chairman G. Michael Hostage was trying to put together a group to buy the hotel and restaurant chain from its parent company, Imperial Group PLC, through an LBO.<sup>49</sup> But there are several outside bidders who were also showing interest in acquiring Howard Johnson's.

Another lodging chain that has been considered a likely candidate for an LBO is Hilton Hotels Corp. Investment banking sources had been speculating that chairman Barron Hilton may attempt an LBO. Analysts who followed Hilton have indicated that "a deal to take the company private in a LBO would not be unreasonable"<sup>50</sup> considering that the recent rejection of a Hilton casino license request in Atlantic City might "make Hilton's management more amenable to running a private company."<sup>51</sup>

Also, the anti-takeover provisions which were intended to thwart hostile takeover attempts by outsiders and which were approved by Hilton's shareholders in their annual meeting of May 6, 1985, "would not impede a board-approved LBO"<sup>52</sup> For this reason, the anti-takeover measures appeared to have laid the groundwork and buy time for Barron Hilton's management group to structure a possible LBO. For the present, "analysts believe Barron Hilton intends to take the company private within the next five years through a LBO"<sup>53</sup> They see the upcoming sale of the Atlantic City casino as "the first step in taking the company private"<sup>54</sup> since it would enable Hilton to raise funds to eventually undertake the buyout.

### Conclusion

LBOs have experienced remarkable growth in recent years. It is easy to see why buyouts have become so popular. They can be rewarding for all participants. Equity investors can achieve returns that would be unavailable elsewhere with comparable risk. Managers-entrepreneurs can receive a unique opportunity to expand their business horizons. Selling shareholders are able to liquidly assets that would otherwise be tied up, while receiving a premium for their shares. Similarly, investment bankers and other packagers can receive colossal fees and a share of earnings.

Due to the substantial risks associated with LBOs, there will be buy-outs which do not prove successful. But for those that do, the rewards could be outstanding for the management team. Moreover, LBOs will usually result in significant productivity gains for the new private company as well as higher compensation for the owners-managers-entrepreneurs.

Opportunities remain for successful LBOs in the hospitality industry, subject to the continuation of a positive environment for them in the future. Yet the proper balance of rewards and risks will be essential in identifying prime targets. At this time, everyone seems to be watching Denny's and ARA to see if their deals prove successful. Should that be the case, other suitable candidates among hospitality firms are likely to follow suit, hoping to benefit from the potential rewards of LBOs.

*Acknowledgement: The author expresses her sincere appreciation to Diane Withrow and Richard Swentzel, students in the School of Hospitality Management at Florida International University, for their research assistance.*

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- <sup>28</sup>A class action suit was filed on behalf of the Denny's shareholders, representing the difference between the \$43 a share offered and the original \$45 a share bid.
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