Emerging Markets Queries in Finance and Business

The history of junk bonds and leveraged buyouts

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Abstract

Leveraged buyouts (LBOs) and their effect on the economy (following their history that started in 1919 with the first LBO of Ford Motor Company) cannot be adequately discussed without taking into consideration the junk bonds. The reason for this necessary linkage is directly connected with the power that rests in the junk bonds, because they are used to finance LBO deals. The original-issue high-yield debt instrument, the so-called “junk bond” innovation, was pioneered by Michael Milken of Drexel Burnham, providing many hostile bidders and LBO firms with the enormous amounts of capital needed to finance multi-billion-dollar deals. The history of these two instruments goes hand in hand, as for example, the conjunction between the U.S. recession of the early 1990s along with the junk bond market crash following the fall of the investment bank Drexel Burnham Lambert, brought the first LBO wave (the one that started in 1980) to an end. This is not the only example that shows a true connection between LBOs and junk bonds. This paper aims to bring into light the liaison that exists between these two instruments and the history that was created by the financing of LBOs with junk bonds. The present article will bring into focus the speculations that rests on the idea that the junk bonds has proven to be a life saver to big leveraged buyout groups as companies are able to get access to funding as investors look to invest in companies with high yields. Apart from this subject, this paper will try to figure out the role that the junk bond market plays in new LBO’s, especially the ones created after 2012 (there was a slowdown in the LBOs activity after the financial turnover from 2008, and only after 2012 we can observe an improvement in the leveraged buyout market). This research paper will try to stimulate thinking about the effects that are generated on a market by a LBO, the power that exists behind a leveraged buyout (e.g. the junk bonds) and the connection that makes them prevail and become powerful, mainly together.

Keywords: Leveraged Buyouts; Junk Bonds; High Yield Bonds; Mergers and Acquisitions

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1. Main text

The existing academic literature and its further expanding on the subject of corporate finance does not agreed upon a precise definition of the terminology of a leveraged buyout (LBO). An early definition of this concept stated that a LBO is “a transaction in which a group of private investors uses debt to purchase a corporation or a corporate division” (Palepu, 1990). These private investors consist of the management of the target company, a single or a consortium of private equity firm(s) and, often, third-party investors. Their purpose is to obtain an important part of the bought-out company.

One of the core characteristics of LBOs is the substantial debt financing against the target company’s assets from “banks and from buyers of subordinated public debt, which in the 1980s became known as junk bonds” (Shleifer and Vishny, 1997). But, there is great doubt regarding the notion of a leveraged buyout: “The greatest ambiguity about what constitutes an LBO concerns the degree to which the purchase is financed with debt” (Garfinkel, 1989). The author also states that debt finance provides about 80% to 90% of the funds needed for the purchase. Other authors consider a 85% to be the figure for the debt financing (Easterwood et al., 1989). A more generous percentage is given by (Kaplan and Strömberg, 2009) who are arguing that a “buyout is typically financed with anywhere from 60 to 90 percent debt”. Other sources qualify a transaction as being leveraged (eg. highly leveraged) when at least 50 percent of the total sources of the acquisition are financial liabilities (FASB, 1988). A leveraged buyout is financed both with equity and debt, consisting therefore from a considerable share of debt (or other debt-like instruments). At the beginning of the LBO phenomenon, one of the key factors was the ability to receive financing for companies below investment grade rating, commonly referred to as junk bonds (they also received names such as “securities swill” or “toxic waste”) . Similar considerations were subject to the definition of “highly leveraged transactions” (HLT) by the US authorities under the auspices of the Federal Reserve Board to mitigate the advancing default risk. One of the guidelines related to the capital structure demands that the financing either doubles the borrower’s liabilities and results in a leverage ratio greater than 50%, or increases the leverage ratio higher than 75% (Lenz, 2010). High-yield bonds in LBO financing can be structured in a variety of forms but most frequently have a maturity of seven to ten years, bear annual cash-interest payments and are fully repaid at term (Pindur, 2007). The junk bonds were the fastest growing financial instruments in the US capital markets in the 1980s and they are still the most controversial tool.

The 80s witnessed a vast attention given to the junk bond concept by the writers and the fund managers diversified their portfolios into this friendly financial instrument (the same appreciation of the instrument can be found in Levine, 2012). Investors found the junk bonds as being attractive because they could be resold in a liquid secondary market (Taggart, 1988). But in the spring and summer of 1989 the bubble burst and the issuers of junk bonds began to default as they were sliding into an inevitable faith: bankruptcy. Suddenly, the junk bonds became a negative instrument (Edward et al., 1987; Bruck, 1989; Yago, 1991; Zey, 1993; Yago and Trimbath, 2003) that brought various outcomes for the junk bond issuers: they faced cash problems that arise sooner or later. The connection between high yield bonds and the wave of corporate restructuring has placed the junk bonds and the people who crafted and marketed them at centre stage. More attention raised the securities investigation of Drexel Burnham Lambert and Michael Milken (the controversial financial innovator also known as “The Junk Bond King” who made millions of dollars for himself and his Wall Street firm by specializing in bonds issued by “fallen angels”) resulted in a settlement of $650 million by Drexel Burnham and the indictment of Milken. The Wall Street history witnessed its largest bankruptcy in February 1990 when Drexel Burnham, built mostly with high yield bonds, collapsed.

Following a period of stagnation also on the leveraged buyouts market and in the academic literature for this subject, the literature review guides us towards the 2007s, when we experienced a credit crisis, when the subprime mortgage market began to fall down. After the rescue of Bear Stearns by J.P.Morgan with government assistance, the financial market meltdown has started from 2008 (Maxwell and Shenkman, 2010).
The presented study’s research approach is of an exploratory nature and it is motivated by the relatively rare total value research in the area of finance and strategic management regarding the leveraged buyouts, especially in terms of performance and relationship with the junk bonds phenomenon. One of the key reasons for the lack of studies in this area was the traditional difficulty of accessing data. Most studies on this topic have been published in the 80s and early 90s, when the LBO phenomenon has become a matter of public and academic interest. Moreover, the dual and contradictory approach regarding the positive and negative influence of the junk bonds power in a LBO supported the motivation for this paper.

2. The Historical Evidence

The LBOs came to fame during the 1980s in the United States when they contributed as a major ingredient to the hostile takeover boom at that time. While the LBOs activity has increased in that decade, (Jensen, 1989a) predicted that companies purchased the debt will become, finally, the dominant form of corporate organization. Jensen argued that the LBO type of organizations combine significant concentration of ownership stakes, management performance based, highly leveraged capital structures and active governance conducted by the private companies that invest in them. According to Jensen, these structures are superior to typical public corporations that have dispersed shareholders, a low leverage and weak corporate governance.

The American corporate sector had experienced a dramatic increase in leveraged buyout activity between 1979 and 1989 with over 2,000 LBOs valued in excess of $250 billion (Opler and Titman, 1993). The new phenomenon reaches a pick in 1989, when Private Equity firm Kohlberg, Kravis & Roberts acquired RJR-Nabisco for $25 billion in a leveraged buyout takeover, a transaction almost double the size of the largest previous acquisition to that date, the $13.2 billion Chevron purchase of Gulf Oil in 1985 (Jensen, 1989b).

A few years later, Jensen’s prediction seemed premature. The extraordinary returns on early LBO investments had led to an inflow of large amounts of capital from investors into LBO funds (Kaplan and Stein, 1993). Both the number of transactions and the average size of the deals had increased significantly during the ‘80s. However, capital market turbulence in the late 1980s, especially following the Black Monday on 19th October 1987, as well as changes in the financial market environment and defaults of a range of highly levered target companies led to a rapid decline of leveraged buyout activity as well as a breakdown of the associated high yield (or junk) bond market until 1990–1991 (Kester and Luehrman, 1995; Allen, 1996). The global stock markets crash from October 1989 and the recessionary economic development until the end of the first Iraq war in 1992 prompted an abrupt end to the positive and growing fundraising climate. Therefore, the high-yield bonds market collapsed, and a large number of LBOs were led to bankruptcy; moreover, the public companies LBOs (the so-called public-private transactions) disappeared in the early ‘90s.

There is a considerable wide belief that junk bonds put a crushing burden on leveraged buyouts, but the evidence indicates otherwise. It demonstrates that the added debt offers additional incentives to management to reduce costs and improve performance in key areas. Contrary to the popular belief, the junk bonds have not primarily been used to fund hostile takeovers, but to generate economic value through aggressive business development strategies. (Yago, 1991) The junk bonds were associated with rapid growth in sales, productivity, employment and capital spending. Therefore, what seemed to be the death of the LBO expansion was instead a helpful instrument for the high yield firms that gained an advantage in terms of performance. Junk bonds were not harmful for the American economy, but they supported and developed it in regards of productivity, gains, efficiency and expansion.

Apart from all the above, it would be a great mistake not to mention the fact that the connection between the leveraged buyouts and the junk bonds was realised before the 1980s events. The high-risk bond and the LBOs relationship is dating back in 1901 when J. P. Morgan realised the merger of eight steel companies at a cost of $1.4 billion, more than a third of this money being took on debt (Anders, 1988).
3. The Holistic Evidence

Through a quantitative research and review of data, we can observe a variation in rating class within the high yield market during decades, variation that is directly linked to the LBO phenomenon. Table 1 shows the fluctuation over time of the junk bonds from twenty years from 1986, according to Credit Suisse bond ratings. For example, if we compare the 1986 situation with the reality from 1991, we can observe an inversion in terms of a higher rating awarded to the B bonds in the first analyses year (29.9% were BB bonds and the majority, 63.3% were rated B bonds) in comparison with the previous year when the BB hold the majority (76.9% of high-yield bonds issued were rated BB and only 12.8% were rated B).

Table 1. High Yield New Issues by Rating (1986 – 2006)

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<tr>
<td>BB</td>
<td>29.9%</td>
<td>76.9%</td>
<td>34.5%</td>
<td>55%</td>
<td>38.9%</td>
</tr>
<tr>
<td>B</td>
<td>63.3%</td>
<td>12.8%</td>
<td>59.5%</td>
<td>43.1%</td>
<td>53.2%</td>
</tr>
<tr>
<td>CCC</td>
<td>1.8%</td>
<td>0%</td>
<td>0.8%</td>
<td>1.1%</td>
<td>7.7%</td>
</tr>
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</table>

Source: Credit Suisse

As all data confirm the evidences presented in the historical part, by observing the activity of LBOs and Mergers & Acquisitions from Fig. 1, we can affirm that during periods of increased buyouts (between 1986 and 1991), companies find their funding at the lower end of the rating spectrum. Also, during times with higher defaults, firms may encounter difficulties in issuing debt in the lowest rating classes, such as B and below.

Fig. 1. Completed Mergers & Acquisitions and Leveraged Buyouts (1981-1996), Source: Data collected from Baker and Smith (1998)
After the events from early 1990s, the market of junk bonds was exhausted and later in that decade, experiencing economic prosperity and being less liquid after the Drexel Burnham event, the junk bonds were blooming again. The default rates climbed after 1990, reaching 10.3% in 1991 (Altman and Fanjul, 2004). But, once more their reign was about to end. So, in 2001, 11% of U.S. junk bond issues defaulted (Brealey et al., 2011) and companies owning junk bonds faced again difficult times.

4. The junk bonds and LBOs current trends

Nowadays, there are big leveraged buyout groups that have gained access to private equity funds that have succeeded by selling junk bonds lately, such as Caesars Entertainment (in the 3rd quarter of 2013 had a $2.15 billion offering backing a debt repurchase) and Dell (in September 2013, Dell priced its $1.5 billion offering backing its LBO by private equity concern Silver Lake). Three top loan issuers are rated below B and all three are a result from LBOs. On the other hand, two of the top 10 biggest high-yield bond issuers are companies that were previously rated as “fallen angels”. Moreover, we can observe in Table 2 that 7 of the top 10 high-yield loan issuers are from leveraged buyouts, and only 2 of the top 10 high-yield bond issuers have origins in the same category.

![Fig. 2. Top 10 High Yield Issuers (2012)](image-url)
In 2012, the junk bond funds witnessed an injection of capital, cash that has to be invested in new deals. The capital markets have reopened to highly indebted companies after central banks moved to keep official rates low and sentiment in US and European markets has improved (Bullock and Thomas, 2012). Given the generous yields available from the high yield sector and the current low level of defaults, investors may prefer high yield over investment grade, as shown in Fig. 2.

![High Yield Spreads and Defaults](image)

Fig. 3. The spread between the yield of the J.P. Morgan Domestic High Yield Index and the yield on comparable maturity Treasury bonds

As we can observe from Table 3, the volume of junk bonds issued to support the LBOs has witnessed, at a global level, an increase after the financial crisis. Even if the amounts of bond issued in US is much bigger than in Europe, there is a massive increase last year, with more than 150%. Therefore, there is hope that Europe will emerge slowly from its recessionary, forecasting that in 2014 no significant global shocks will derail its recovery. However, the economic growth will be modest, with strong regional variations as the euro area periphery remains weak (Moody’s Global Credit Research, 2013).

Table 2. The volume of high yield bonds issued to endorse the LBOs (2005-2013)

<table>
<thead>
<tr>
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<th>US ($B)</th>
<th>Europe ($B)</th>
<th>Global ($B)</th>
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<tbody>
<tr>
<td>2005</td>
<td>21,2141</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>2006</td>
<td>34,4500</td>
<td>7,2670</td>
<td>43,6534</td>
</tr>
<tr>
<td>2007</td>
<td>50,8355</td>
<td>5,2064</td>
<td>57,8476</td>
</tr>
<tr>
<td>2008</td>
<td>28,9730</td>
<td>0,1500</td>
<td>29,1558</td>
</tr>
<tr>
<td>2009</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2010</td>
<td>13,7200</td>
<td>1,6981</td>
<td>16,0213</td>
</tr>
<tr>
<td>2011</td>
<td>15,4970</td>
<td>2,9917</td>
<td>19,6907</td>
</tr>
<tr>
<td>2012</td>
<td>19,5320</td>
<td>2,4096</td>
<td>22,6294</td>
</tr>
<tr>
<td>2013</td>
<td>16,6400</td>
<td>6,3798</td>
<td>25,1187</td>
</tr>
</tbody>
</table>

Source: Standard’s and Poor’s
Note: The credit crisis halted the M&A activity in 2009 and there was zero high yield issuance for supporting the LBOs
5. Conclusion

In the 1980s, high yield securities played a constructive role in enabling the restructuring of companies in various key industries and the outbreak of a new wave of firms that were to operate in new and innovative areas. These securities were an important part of the economic environment, providing public corporations with funds that allowed them to surpass competitors in their industries by an improved performance. After the 1990s, the future of high yield financing experienced periods of decline, stagnation and also growth. However, something is certain: if a company has difficulties in obtaining capital, the same thing is happening with a country’s economy that experiences obstacles in its development and growth.

The high yield market saw an explosive growth in 2005-2006, a bubble that was only foretelling the financial crisis that was about to come. Indeed, LBO-related high-yield issuance peaked at $51 million in 2007 only to slump to zero in 2009, according to Standard & Poor’s LCD.

The LBOs became an important part of the junk bonds’ story, because it is estimated that high yield securities may have accounted for as much as 25 to 30 percent of leveraged buyout financing (Yago, 1991). Throughout history and due to events that changed the way junk bonds or LBOs were perceived, we can affirm that high yield bonds were and are an essential part of most leveraged buyouts.

After the crisis, the market started to regain its faded powers. It is expected that the high-yield and leveraged loan issuance volumes in 2014 to be similar to the record-high levels witnessed in 2013. It is expected a rising in treasury rates to be the main driver of returns in US and European high yield in 2014, with projected returns of 5% and 5.5%, respectively. Default rates are believed to remain contained, with exceptionally low levels in Europe. (Miller et al., 2013)

The future of high yield and leveraged buyouts is going to be dominated by new corporate organizations that aim, through high yield financing, to create new opportunities and to innovate the social and economic environment. The definition of the future economy lies in balance.

Acknowledgements

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