The Leveraged Buyout of Bajaj Auto

Bajaj Auto Limited (BAL) is a sitting duck. The company has many desirable attributes of an LBO candidate - a huge cash pile, stable cash flows, a large un-utilised debt capacity, and a low stock price. Someone who has lots of courage, and connections, but not necessarily his own capital, can pounce on this company and take it over at Rs 600 per share and still make a lot money for himself on this deal. Note, that I mentioned that one does not need one’s own capital to take over BAL at Rs 600 per share. In an LBO one does not use one’s own money to take over a poorly performing company like BAL. Instead, one uses the cash resources and the un-utilised debt capacity of the target company itself to take it over.

Let us do this experiment. Let us think how we can take over this company at Rs 600 per share using lots of borrowed money. And let us see how we can repay all that debt and still make money for ourselves.

BAL has 11.9 crore shares outstanding which are currently quoting at Rs 400. At that price the market capitalisation of the company is Rs 4,760 crores. To take over 51% of the company at Rs 600 per share, we would need Rs 3,641 crores. Suppose, all of us floated a company with very little equity capital but this company was able to borrow Rs 3,641 crores at 18% p.a. for three months. This is where the “connections” referred to above would come in handy.

We will call our company Bajaj Auto Holding Company Limited (BAHCL). Then, as soon as BAHCL had access to the borrowed funds of Rs 3,641 crores, it would make an open offer to the shareholders of BAL. The offer would be for acquiring 51% of the outstanding shares of BAL. The offer price would be Rs 600 per share, which is 50% above the current price. Why would BAHCL make its offer at such a high premium above the prevailing market price? The reason is simple: to give a huge incentive to the shareholders - both institutional and minority - to tender their holdings to BAHCL at Rs 600.

Suppose that sufficient number of BAL’s shareholders were convinced and tendered their shares in the company to BAHCL. Then BAHCL would acquire 51% of BAL which would then would become its subsidiary. BAHCL would also end up with a debt of Rs 3,641 crores on its balance sheet. What would BAHCL do next?

First, BAHCL would appoint so many additional directors which would enable it to control the board. Next, BAHCL would make BAL take a loan, offering its operating cash flows as collateral. The period of the loan would be 4 years. The interest rate would be 15% p.a. How much loan would BAL raise? To answer this question, we need three figures: (1) the expected cash flow from operations of the company: my estimate of this number is Rs 500 crores per annum; (2) the interest coverage ratio required to be maintained: my estimate is 1.5 times; and (3) the interest rate to be paid: my estimate is 15% per annum.

Once we have these numbers we can figure out how much debt could we put on the balance sheet of BAL. If annual cash flow from operations is Rs 500 crores, then to maintain an interest-coverage ratio of 1.25 times, annual interest outgo must be Rs 400 crores, which at 15% p.a. translates into a loan of 2,667 crores. In other words, we could get BAL to raise debt of Rs 2,667 crores, once BAHCL had taken control of the company. However, we would restrict the total debt taken by BAL to 1,304 crores.

Next, the board of directors of BAL would liquidate the investments and financial assets portfolio of BAL, which according to my estimates should result in cash of approximately Rs 2,500 crores. Adding the loan proceeds of Rs 1,304 crores, BAL would now have 3,804 crores of cash on its balance sheet. BAL would then give a zero-coupon loan of this Rs 3,804 crores to its holding company BAHCL. This Rs 3,804 crores of funds would just be sufficient to retire the debt taken (along with 3 months' interest) by BAHCL to take over BAL. The effect of this transaction would be that the outside debt on the balance sheet of BAHCL would be replaced by the debt from its subsidiary, BAL. BAL would, in effect, have financed its own takeover by BAHCL.

Having taken control of BAL, what would we, the owners of BAHCL, do next? We would ensure that the affairs of BAL are managed in a manner which would reduce its debt levels of Rs 1,304 crores to nil within 3 years. How will we do this? Here's how:

First, all available cash flow from operations of BAL would be dedicated to payment of interest expense and paydown of debt.

Second, dividend payments to equity shareholders would be suspended, which would make approximately Rs 100 crores per annum available for debt reduction.

Third, more funds would be released as the interest expense on the income statement of BAL would reduce its income tax liability very significantly. At least Rs 150 crores per annum would be generated from this source which would be utilised to pay down debt.

According to my estimates, BAL would comfortably be able to pay off all its debt within 4 years of the LBO. At the end of this four-year period, BAHCL would still own 51% of BAL which by then would be a debt free company again. At this point BAHCL could sell its stake in BAL at estimated 20 times cash flow to a strategic buyer. Even if we assume no growth in cash flow from operations over the four-year period, the exit value for BAHCL would come to Rs 5,100 crores. Of this, Rs 3,804 being debt owed by BAHCL to BAL would be repaid to the company, Rs 160 crores would be paid as long-term capital gains tax, and the balance Rs 1,136 crores will be paid to us, the owners of BAHCL as liquidating dividend. This Rs 1,136 crores would also be our post-tax return over four years on nil initial investment.

What is point of the above experiment? The point is to demonstrate that at the prevailing market price of Rs 400 per share, BAL is a prime candidate for an LBO. This is because: (1) the company is virtually debt free; (2) it is sitting on a pile of cash of Rs 2,500 crores, the value of which is not being reflected in its stock price; (3) the company's operating business is generating significant amount of cash which can be used to raise debt; and (4) since the company has no debt, in the absence of interest tax shield, a significant amount of this cash generated from operations is transferred to the government through income tax.

An LBO of Bajaj Auto at Rs 600 per share would create value for its existing shareholders. It would also create value for the shareholders of the LBO promoter- BAHCL. Moreover, it would not jeopardise the careers of the employees of BAL. Then, do I think that this LBO would happen? Of course, not. The promoters of BAL, who control 42.7% of the shares of the company, would not want it to happen. But they should. In fact, they could take the company private at Rs 600 per share using the same procedure described above. The only difference is that instead of BAHCL doing it, it will be the promoters of BAL who could do

it. They could use the cash hoarding and the un-utilised debt capacity of BAL to increase their stake in it to 100%.

Note

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