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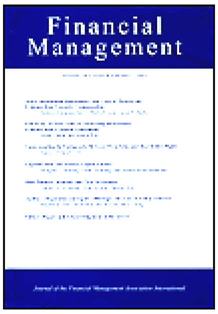

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Controlling Financial Distress Costs in Leveraged Buyouts With Financial Innovations

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■ This study investigates innovative methods used to reduce the cost of financial distress in leveraged buyouts. These methods include strip financing, where debt and equity are shared by the same investors, the use of LBO specialist sponsors, who represent both equityholders and debtholders, and debt provisions which allow the postponement of cash outflows. In theory, methods like these encourage stockholders and debtholders to reallocate their claims to a firm's cash flow with minimum rancor (see Jensen [21] and Wruck [44]). Thus, they have the potential to significantly reduce the direct and indirect costs of financial distress.

This study offers evidence on whether such innovative financing methods reduce the expected costs of financial distress in LBOs. I document the prevalence of these financing techniques in a sample of 63 LBOs and ascertain whether they are associated with lower risk-adjusted financing costs. Other things being equal, firms which control the deadweight costs of debt financing should have a lower cost of capital.

Evidence on the impact of LBO financing techniques addresses the broader argument that highly levered firms have become more sophisticated in managing the deadweight costs of debt. Such evidence is also relevant in addressing policymaker concerns about the potential ad-

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Abstract

Leveraged buyouts have often been funded in ways which appear to reduce the risk and cost of financial distress. Leveraged buyout financing methods include the use of specialist sponsors, strip financing, covernants which require that excess cash flows be paid to debtholders, and debt provisions which allow...

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