“Leveraged recaps”: unlocking hidden balance sheet value

In a leveraged recap, a firm borrows to distribute the proceeds to its shareholders either by repurchasing its own shares or by paying a special dividend. Most large U.S. firms borrow and do buybacks every year, but the term “leveraged recap” is typically reserved for firms that announce the debt issuance and one-time distribution simultaneously and where the distribution is material and is executed over a short period. In today’s environment, there are some very powerful and unique forces that make leverage recaps potentially more compelling for large U.S. corporations.

WHY NOW?

- **Positive market response:** While the positive investor reaction to leveraged recaps has been well documented over the years, firms announcing leveraged recaps since 2011 have outperformed the market by close to 20% on a risk-adjusted basis. What drives this unprecedented value creation in today’s environment?

- **Disconnect between cost of equity and cost of debt:** One of the key drivers of today’s value creation through leveraged recaps is the record disconnect between debt and equity. While the cost of debt has continued to decline to new records thanks to low Treasury rates and tightening spreads, the cost of equity has not. Despite the recent rally in equity markets, valuation multiples are still low from a historical perspective.

- **Record EPS accretion:** As a result of the record low cost of debt and persistently low P/E multiples, a typical S&P 500 firm can achieve 7 to 8% accretion today if it repurchases 10% of its stock with 10-year debt (see figure below).

- **Favorable valuations:** Most companies undertake leverage when the transaction is accretive – buying shares at low P/E multiples with tax deductible debt. Recent evidence suggests that despite the additional leverage in these transactions, P/E multiples do not contract, leading to significant value creation.

- **M&A and recap not mutually exclusive:** Many large cap firms have ample flexibility within their rating or via large cash balances to execute a large distribution and still have sufficient flexibility for M&A.

- **Hedge fund activism:** Activist funds are more vigorously seeking to unlock value. Boards may decide it is better to act now than be forced to take even more aggressive action.

- **Tax shield:** Equity has been subject to double taxation compared to debt. As a result, in non-crisis market environments, more leverage tends to lower the cost of capital for most large cap firms thanks to the tax shield on debt.

- **Signaling:** A board would only announce a major debt financed distribution if it is confident in the firm’s future prospects. Thus leveraged recaps help signal under valuation in today’s depressed valuation environment.

WHO SHOULD CONSIDER A LEVERAGED RECAP?

- **Firms with low leverage and undervalued equity:** Many large companies preserve high credit ratings and minimal leverage levels (particularly on a net-of-cash basis), and can use their debt capacity to repurchase undervalued equity. Historically, most S&P 500 firms accelerated their share repurchases when equity was overvalued (e.g., 2005-2007). Today there is a unique opportunity for some of them to improve the ROI of their share repurchase programs.

- **Firms with credit rating flexibility:** Many large companies can raise large amounts of debt within their current rating category or a one notch downgrade. That means that many recaps can be executed with only a marginal impact on a company’s borrowing costs.

- **Large cash balances “trapped” offshore:** Investors are seeking incremental return of capital. They are increasingly impatient about the sizable and seemingly “inaccessible” cash balances of large global companies. Domestic debt financing allows firms to return the capital without having to repatriate the offshore funds.

- **Not for everyone:** While leveraged recaps can unlock significant value for some companies, a leveraged recap is not advisable for companies with limited financial and rating flexibility, sectors with high costs of financial distress, and when access to capital markets may be jeopardized as a result of the recap.

Illustrative EPS accretion of buybacks for S&P 500 companies

Assumes buyback size of 10% of market capitalization, 5% repurchase premium, 35% marginal tax rate and Bloomberg fair market value index cost of debt for BBB rated issuer
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