Stapled Finance

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What Is Stapled Finance?

Acquisition financing, pre-arranged by the seller

- Say, a firm ("target") is put up for sale by its owner ("seller")
- Seller's advisory IB puts together a loan commitment, before the bidding contest starts
- The winner of the bidding contest can get that loan, just by signing the dotted line
  - This is an option, not an obligation
  - The loan is available to any bidder (who wins)

More Details

According to the business press, stapled finance ...

- was first offered in 2001
- quickly became common in M&A deals
  - Offered in 39% of 2004 US deals involving PE funds
  - Offered in 90% of 2006 European deals between PE funds
- is often accepted by private equity funds
- is offered on “aggressive” terms: cheap, large loans

Some Quotations from the Business Press

- "Today, a deal without stapled financing is mostly the exception rather than the norm," said an executive with one Wall Street investment bank. It is particularly likely to be offered, he added, in deals where the seller is a leveraged buyout firm. [...] most buyout executives contacted for this article agree that the staple financing typically represents the most generous deal available."
  ("Popular LBO staple financing raises eyebrows," *Dow Jones News Service*, January 10, 2005.)

Some Quotations from the Business Press (cont'd)

- "Staple financing was offered by banks this year in about 90 percent of the auctions in Europe where buyout firms sold businesses to other buyout firms. [. . .] Staple financing is rapidly becoming standard practice due to the increasing importance of private equity as buyers of businesses." ("'Stapled' loans create potential conflicts for merger advisers," *Bloomberg*, October 24, 2005.)

Some Quotations from General Partners in PE funds

- "Banks are being pressured to come up with aggressive staple financing and sometimes it means they are not comfortable with the amount of debt they are putting forward. In one case recently, the bank actually told us it didn't want to lend the amount included in the staple package. Inevitably, that made us nervous."
- "With the advent of staple financing and leverage multiples where they've been, we have seen some transactions where banks are willing to lend and private equity firms are put off because the staple finance package implies a valuation they're not comfortable with."

("Private equity in 2006: The year of living dangerously," *Financial News*, February 2006.)

Some Explanations (Mostly: Business Press)

- Possibility of attracting bidders (who like financial leverage)
- Less duplication of due diligence to prepare initial bid
- Bidders know in what range the seller expects them to bid
- Time savings: Bidders know what sort of financing is available, can close deal quickly
- Reduced risk: transaction will not fall through because winner could not line up financing (at reasonable rates)
- Certification: IB makes valuation credible by putting its money where its mouth is

Some Unanswered Questions

- Can we explain the popularity of stapled finance?
- What other effects/benefits/drawbacks does stapled finance have?
- Why are the terms of stapled finance often deemed "aggressive"?
  (Some lenders commit to lend but don't really want to...)
- Why is stapled finance so popular with PE funds?

Messages of the Paper

- Stapled finance makes bidders more competitive
- The presence of "financial buyers" is central to this effect (e.g., PE funds / LBO funds)
- The stapled finance terms *must* be "aggressive":
  The lender expects *not* to break even!
  $\Rightarrow$ Stapled-finance buyout loans are *truly* toxic!
- The seller must compensate the lender ex ante
- Nevertheless: The seller benefits!

Related Literature

- Leverage & M&A
  - LBO benefits if there are agency problems (Jensen, AER 1986)
  - Increase target's leverage before sale $\Rightarrow$ increase "control premium" (Stulz, JFE 1988; Israel, JF 1991)
  - Increase bidder leverage to reduce free-riding in tender offers (Mueller & Panunzi, QJE 2004)
- Literature on M&A contests using auction models
  - (see paper for references)
- Literature on "bidding with securities"
  - Benefits from requiring bids in the form of debt/equity/royalties/etc.
  - Examples: Spectrum auctions, oil lease auctions
  - Our bidders pay cash, and they can borrow if they wish
  - Asymmetric bidders: Financial buyers vs. trade buyers

Related Literature (cont'd)

- Stapled finance analyzed empirically in:
  Boone and Mulherin (WP 2008), "Do Private Equity Consortiums Impede Takeover Competition?"
  ($\Rightarrow$ Bidding more competitive)

Details of the Model

- Two bidders, "private values" ($\Rightarrow$ bidder-specific synergies)
  - True value not observable (yet)
  - Bidders observe i.i.d. signals s_i
  - True value equals s_i with probability φ
  - True value equals equals random value with probability $(1 - \varphi)$ (same distribution as s_i)
- Bidders are **not** financially constrained $\Rightarrow$ Strategic effects!

Details of the Model (cont'd)

Timing:

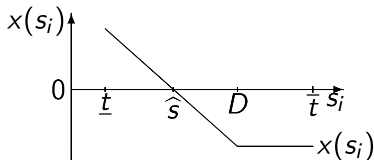
- Seller's IB prepares loan commitment before bidding starts
- Bidders privately observe signals
- Bidders participate in ascending auction: last remaining bidder wins; if tied $\Rightarrow$ coin toss
- Winner has the right (but not the obligation) to accept the stapled finance: borrow L, promise to repay D
- Valuation realized; debt payments (if any)

Effects on the Bidding

- Given her signal, a bidder finds the stapled finance terms either attractive or unattractive
- Lender has written an option that the winning bidder exercises only if it is in the money
- Option to accept has positive expected value, or zero
- Option increases bidder's valuation of "winning"
  $\Rightarrow$ Raises bid by the value of the option

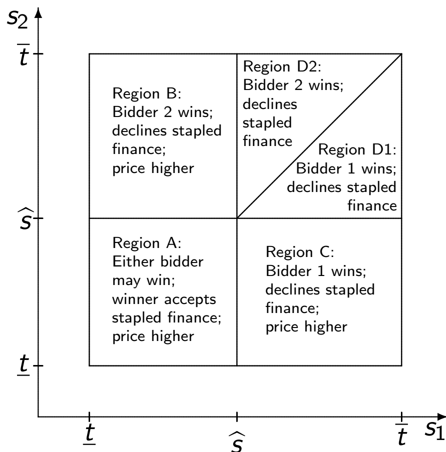
When Do Bids Increase?

- Financial buyers plan not to integrate target; instead, hold it as a portfolio company
- Limited liability: Debt is supported by target's cash flow, only!
- A given debt package is most attractive to the most pessimistic bidders; value, given signal s_i:



- Low-signal bidders ($s_i < \widehat{s}$) bid as if their signal was $\widehat{s}$.

The Outcomes for Different Signal Realizations



The Seller's Net Benefit

- Seller's expected net payoff is increased with **any** stapled finance package!
- Bidders' expected payoffs are reduced (Prisoners' Dilemma)

More Results

- Trade buyers: incorporate target firm, no limited liability
  - Don't accept stapled finance
  - With one financial buyer: seller still benefits! (Financial buyer benefits, too; trade buyer suffers.)
  - But: stapled finance should not be too attractive
- Other auction types, e.g., first-price auction: same results

More Results (cont'd)

- Reserve prices: stapled finance is better But: with 1 financial buyer and 1 trade buyer, should use *both* stapled finance and reserve prices!
- Alternative signal technology:
  value $= V(s_i, \theta) \sim [V_a, V_b]$,
  where θ is a random variable;
  $\Rightarrow$ same results

The IB's Compensation

- IB requires compensation: if stapled finance offer is accepted, expected net payoff is negative
- In practice:
  - Arranging high-yield debt is profitable
  - Seller can agree to retain IB for other fee-based services
- Practitioners worry about incentive conflicts: "advise" seller to accept a bid from a bidder who will accept the loan.
  - If anything, ...
  - conflicts of interest obvious ...

Alternative Explanations (Mostly: Business Press)

- Possibility of attracting bidders (who like financial leverage)
- Less duplication of due diligence to prepare initial bid
- Bidders know in what range the seller expects them to bid
- Time savings: Bidders know what sort of financing is available, can close deal quickly
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Summary of Main Results

- Stapled finance availability leads to higher prices
- Aggressive terms: Lender expects not to break even
  - ⇒ Expect stapled-finance buyout loans to perform poorly
- Smart sellers should arrange stapled finance if they expect interest from financial buyers
  - ⇒ Many PE funds arrange stapled finance when selling assets

Thank you!

Example: Two Financial Buyers

- Two financial buyers, receive perfect signals
- Realize \$1 (w/ Prob. 3/4) or \$0 (w/ Prob. 1/4)
- Say, $0 < L \leq 1$ and $D = 1$
- With good signal, bid \$1, plan to decline loan
- With bad signal, bid $\$L$, plan to accept loan and default
- Seller expects $\frac{9}{16} \cdot \$1 + 2 \cdot \frac{3}{16} \cdot \$L + \frac{1}{16} \cdot (-\$L) = \$\frac{9}{16} + \frac{5}{16} \cdot \$L$
- Without Stapled Finance: $\frac{9}{16} \cdot \$1 + \frac{7}{16} \cdot \$0 = \$\frac{9}{16}$