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Multi-layered finance a defence against private equity

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Another week, another eye-popping antic from the private equity world.

This time, it involves Sallie Mae, as the American institution that provides student loans is popularly known.

Until recently, it was presumed that financial institutions such as Sallie Mae could not become victims of a leveraged buy-out since these institutions were already loaded up with debt.

But now a $25bn LBO for Sallie Mae, lead by Christopher Flowers, a buy-out specialist, and others, has been accepted.

This has apparently caught many Wall Street financiers on the hop, reportedly leaving some investment banks and hedge funds nursing losses as a result of dramatic – unexpected – price swings in Sallie Mae's debt notes and associated derivatives.

It has also left the listed corporate world feeling doubly nervous. After all, if Sallie Mae has fallen, the question being asked in some boardrooms is whether there is now any listed group that can be considered immune from this ever-swelling private equity threat.

So is there anything that a listed company can do to reduce the risk of becoming a victim of an LBO bid – other, of course, than by unleashing a brilliant corporate strategy or loading itself up with debt before a private equity group pounces?

One idea that is starting to gain interest, and be quietly promoted by investment bankers to their clients, involves the idea of a "multi-pronged" or "multi-layered" corporate financing structure.

What this essentially means, at least according to the bankers, is that the days of looking at companies in terms of a single leverage number is becoming outdated. For though corporate treasurers and chief finance officers used to be paid to develop overarching finance strategies – and sweat blood to keep overall leverage below a certain level, to preserve their credit rating – the birth of tools such as securitisation is creating new options.

Specifically, what some bankers are advising their listed corporate clients to do is consider how they can split their company into separate, ringfenced pools, and then use some of these parts to borrow heavily while leaving other parts relatively unlevered.

The theory behind this is that debt will look less scary to a rating agency (or board of directors) if it involves just a part of the company rather than the whole. Leveraging up certain assets, even in partial manner, can give a company firepower with which to fight off a private equity bid. Even before a would-be bidder strikes, the sheer act of ringfencing assets and borrowing against them can reveal their hidden value to the stock market. It also, of course, removes one of the routes for unlocking value that a private equity group typically takes when it buys a listed group.

This, the theory goes, can partly defang a potential bid.

It is tantamount to some herbivorous dinosaurs stealing a few tricks from a Tyrannosaurus Rex – say, a few teeth – before the latter actually attacks and without entirely converting to the carnivorous cause.

Of course, this strategy does not come without its downside. For one thing, it can be fiendishly complex for a finance department to handle – or explain to suspicious company directors or rating agency officials. It also has a nasty habit of producing lots of banking fees.

Moreover, the multi-pronged approach can still raise leverage in a way that could weaken a company's fundamental health.

Debt remains debt if you mortgage the family silver – however cleverly the transaction might be dressed up in complex securitisation language, say.

Nevertheless, the multi-pronged concept appears to be spreading. Just look at how EMI, the UK music company, is planning to securitise its music publishing rights. Or take a glance at the so-called "opco-propco" trend sweeping the UK retailing world as groups such as Tesco or J Sainsbury try to unlock value from their property companies by ringfencing them from operating companies.

I am told that some large businesses operating in the auto, energy and telecoms sphere are now mulling over the joys of multi-financing too.

No doubt some of EMI's media rivals are considering joining the list. After all, fear can be a potent mother of invention; even, or especially, in the slow-moving world of listed companies when the T-Rex of private equity is snapping ever more hungrily at your heels.

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