Tortoise QuickTake

Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provide a timely update on trending topics in the market.

Greg Haendel: Welcome to the weekly Tortoise credit podcast. I'm Greg Haendel, Senior Portfolio Manager at Tortoise. Does size matter? Aristotle Onassis, the business and shipping tycoon and spouse to former First Lady Jacqueline Onassis Kennedy once said, "To be successful, you must act big, think big and talk big." Apparently the private equity firm KKR, Walgreens CEO Stefano Pessina and pharmaceutical company AbbVie have all taken Aristotle Onassis' wise words to heart this past week. In today's podcast we will explore the viability of the proposed largest leveraged buyout (LBO) in history, Walgreens, revisit some previous record LBO statistics, as well as discuss the largest corporate bond issuance of the year, AbbVie.

According to various news agencies over the past week or so, private equity firm KKR has been in discussions with Walgreens about taking the company private in what would be the largest LBO in history. Should this occur, the total enterprise value for such a deal would be in the range of $75 billion to $85 billion versus the previous record of roughly $44 billion, achieved in 2007 with the LBO of TXU. What could be the motivation for such an LBO and is it even possible?

The motivation for an LBO can be multifold. In its simplest format, the motivation can arise due to a disconnect between the valuation the public markets place on a company or industry versus the valuation the private markets may place on that company or industry. Another motivation to going private is to either execute on a long-term business transformation or pursue internal business initiatives outside of the eyes of public shareholders who may not fully understand or agree with the initiatives or more often than not may be too short sighted in their time horizon (quarter to quarter). We suspect all of the above may be influencing Walgreens desire to potentially go private, especially given their multi-year partnership initiative as well as their ongoing transformational cost initiatives. Further, if history is any guide, Walgreens CEO Stefano Pessina, who currently owns 16% of the company, has a history of participating in LBOs, having previously worked with KKR on the LBO of Alliance Boots in 2007 (which happened to be the largest European LBO in history).

Is an LBO of Walgreens even possible given its sheer size as well as given some of the structural headwinds facing their business? To quote Walt Disney, "It always seems impossible until it's done." Despite some unencouraging thoughts regarding the viability of an LBO from several market pundits, we do believe an LBO of Walgreens is possible under some narrow structural paths. Assuming the high end of the range for enterprise value, $85 billion, using reasonable assumptions we believe this would equate to roughly a $75 share price (33% premium to the stock price prior to the news), $47 billion in total debt and roughly $22 billion in private equity capital needs. Also, this assumes the CEO rolls over his $11 billion equity stake and assumes Walgreens sells their minority stake in AmerisourceBergen, valued at approximately $5 billion. Given the company generates approximately $8 billion of EBITDA per annum, this would equate to slightly less than times leverage post LBO and roughly 6.5 times leverage when you include operating leases. Further, under reasonable debt financing assumptions and cost cutting, we estimate the company would initially generate free cash flow equating to roughly 7% of debt, which is low but not out of context with other LBOs. With lease adjusted total leverage north of six times and free cash flow to debt less than 10%, the unsecured credit rating of a Walgreens LBO would surely be high yield and potentially as low as a single B credit rating.

Although $47 billion of total debt ($30 billion of new debt) sounds like an impossible financing need in the high yield market, there is a narrow path to making it more digestible. Specifically, as seen in the recent deals from Dell Technologies and Charter Communications in 2016, the debt structure of a company can be separated into secured debt, resulting in much

lower "secured" leverage, and unsecured debt as well as structurally senior operating company debt versus structurally subordinate holding company debt. In the case of Walgreens, if they are able to achieve a low investment grade credit rating on secured and structurally senior debt, they may be able to finance a portion of their debt, potentially up to 50%, in the much larger investment grade credit markets. That would leave a large, but still manageable, remaining sum of financing needs to the high yield and bank loan market.

The larger and potentially more difficult financing task within a Walgreens LBO may be the estimated $22 billion of equity financing needed from private equity sponsors assuming the CEO of Walgreens rolls over his 16% equity stake. Although a $22 billion equity check may be too large for one private equity sponsor, a club deal with several private equity firms or one private equity firm teaming up with a large pension or sovereign wealth fund could be achievable and has occurred in several other deals in the past. Further, Walgreens may have additional levers they could pull including a potential sale or spin-off of some of their European operations, which could be worth as much as $20 billion.

While an LBO may be achievable for Walgreens, it is debatable whether it would be a good idea to incur such high levels of leverage at the company, given company-specific and industry headwinds such as reimbursement pressure, Medicare for all legislation, generic drug price deflation and a declining share of front of store sales. To play devil's advocate, Dell Technologies faced several perceived headwinds prior to taking the company private in 2013, and it turned out to be an ingenious move by Michael Dell and Silver Lake Partners. We believe that although an LBO deal of Walgreens may be a stretch, it is certainly possible in today's market environment.

Given the potential size of a Walgreens LBO, I believe it is helpful to briefly compare this to the 10 largest LBOs in history. The largest LBO ever occurred in 2007 when several private equity firms took TXU private with an enterprise value of roughly $44 billion. Unfortunately, this one didn't work out well as TXU filed for bankruptcy protection in 2014. To round out the top five LBOs of all time, #2 was First Data Corp in 2007, #3 was Alltel in 2007, #4 was RJR Nabisco in 1998 and #5 was Equity Office Properties in 2006. In fact, buyout firm KKR was involved in a majority of the top five LBOs in history. When expanding the list to the top 10 LBOs of all time, it is interesting to note that seven of the top ten LBOs of all time occurred in 2006 or 2007, just prior to the financial crisis in 2008.

On the other side of an LBO or large scale merger or acquisition is typically a large debt financing transaction. Consistent with the title of the podcast, size opens eyes, last week AbbVie issued $30 billion of investment grade corporate debt to finance their acquisition of Allergan for roughly $83 billion of total enterprise value. The AbbVie debt raise last week was the largest of the year and the largest since the $40 billion CVS debt raise in March 2018. Further, the AbbVie debt raise ranks as the forth-largest bond sale ever completed, also trailing a $46 billion offering from Anheuser-Busch InBev in 2016 and the record $49 billion raised by Verizon in 2013. Given the dearth of yield globally as well as the strong path to deleveraging identified by AbbVie, their debt issuance was more than two times over oversubscribed with orders totaling well over $60 billion.

Although size still opens eyes, large scale LBOs and M&A as well as near record debt raises in the investment grade corporate bond markets seem to be less of an issue or less of a surprise today. As such, maybe size really doesn't matter too much anymore. According to Dwight D. Eisenhower, "What counts is not necessarily the size of the dog in the fight – it's the size of the fight in the dog."

Thank you for listening, we'll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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