Financing the Acquisition of Kemica Pty. Ltd

A Case Study in Centralized vs. Stand-Alone Financing
Stephen V. Arbogast, Executive Professor of Finance
C.T. Bauer College of Business, University of Houston

Abstract

Energy companies do not make perfect targets for Leveraged Buyouts (LBOs). Most energy businesses are exposed to considerable commodity price risk. Critical sale and input prices can fluctuate 50-100% above their trend-lines. Energy businesses are also characterized by high fixed costs. Such cost structures render them less flexible for coping with price volatility. Fluctuating prices and rigid costs periodically produce margin squeezes that put serious pressures on leveraged financial structures. For this reason, major energy firms employ conservative balance sheets and finance most investments from internal cash generation. Nevertheless, LBOs do occur in the energy business. This case considers the dilemmas posed by a petrochemical acquisition. A major Chinese chemical company is about to acquire an Australian business. Because of the business risks, its initial plan is to use shareholder funds for the purchase. After talking with the present owners, however, it is having second thoughts.

Energy LBOs occur for a variety of reasons. Some involve industry segments well suited for the technique, e.g. pipelines. Others occur because an investor believes the purchase can be made at the bottom of the price cycle. Good timing will mean the venture will experience a cash generation surge, allowing debt to be rapidly paid down. Gordon Kane pioneered this approach for the U.S. petrochemical industry, and other private equity players have since followed his example. A final reason involves the rationale that LBOs can impose discipline on mismanaged operations. Kemica Pty. has a history characterized by regrettable events. The Chinese buyer is harvesting the fruits of that history in the low price it plans to pay. However, it still wants Kemica to perform better in the future. Could that be a reason for employing 3rd party financing and a leveraged capital structure for the acquisition?

Students working this case should first quantify the benefits of using shareholder funds for the acquisition. The methodology discussed in the ***Leveraging Kemica*** case is well suited for this task. They then must assess the intangible benefits of using an LBO structure. Kemica is not the same firm it was in 2000 when its shareholders decided to leverage it with bank debt. Has it changed enough so that the discipline provided by LBO financing is no longer worth the cost?

This case is based upon the acquisition of an Australian petrochemical venture by a Chinese buyer that occurred in 2005.