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The sources of shareholder wealth gains from going private transactions: The role of controlling shareholders ☆

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ABSTRACT

The present study investigates the sources of shareholder wealth gains – as measured by cumulative abnormal returns and premiums – from going private transactions (GPTs). Using data for 314 GPTs from 18 Western European countries, we find that the announcements of GPTs generate a cumulative average abnormal return of about 22% and that pre-transaction shareholders on average receive a raw premium of about 36%. We further find that these shareholder wealth gains increase with the degree of separation of cash-flow and control rights of the pre-transaction ultimate owner and decrease with its ownership interests and with the presence of a second large shareholder. Taken together, these findings support the view that GPTs are expected to mitigate the inefficiencies induced by pre-transaction agency problems between controlling and minority shareholders. Thus, shareholder wealth gains from GPTs reflect the potential additional value that will be created under private ownership.

1. Introduction

The last three decades have seen a number of going private waves in major stock markets around the world, mainly in the US and the UK (see e.g., Jensen, 1993; Renneboog and Simons, 2005 and Renneboog et al., 2007). In these transactions, a privately held entity buys out the shareholders of a public firm and delists it from the stock exchange. Since the late 1970s, the US and the UK have experienced the growth of an important going private market (see, Cumming et al., 2007 and Kaplan and Strömberg, 2009). Every year, dozens of firms change their status to become privately held despite the numerous advantages of being listed in the stock market (media exposure, risk diversification, etc.). GPTs in billions of dollars are now common in these markets. Shareholders of target firms may reap substantial gains when their stakes are bought out at large premiums by the bidders.[1] While several studies have raised questions about the sources of these gains, the majority of the extant research has been confined to US and UK contexts.

The going private literature falls into two main strands. The first strand deals with the determinants of the going private decision (Lehn and Poulsen, 1989; Kim and Lyn, 1991; Weir et al., 2005; etc.). The second strand, which is based on the gain-sharing hypothesis described by DeAngelo et al. (1984), examines the sources of shareholder wealth gains from GPTs. This hypothesis stipulates that minority stockholders in publicly listed firms share in the expected productive gains from going private because of their rights to vote on undertaken decisions, to hold back their shares in tender offer proposals or to sue the firm for wrongful actions. The magnitude and the sources of these gains are examined in the relevant literature using an event study methodology and/or a premium analysis (e.g., DeAngelo et al., 1984; Lehn and Poulsen, 1989; Renneboog et al., 2007).

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[1] When a GPT takes place, public shareholders receive a premium that aims to persuade them to sell their shares. Mean premiums paid in the US and the UK leveraged public-to-private deals range from 32.9% to 56.3% (Renneboog et al., 2007).

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The present study uses this second strand of literature as a starting point and makes three major contributions to the existing research on going private. First, to the best of our knowledge, this paper is among the first to focus on the impact of the pre-transaction agency problems between controlling and minority shareholders on expected wealth gains from GPTs. Previous studies on going private have mainly focused on the US and the UK markets, which are characterized by the predominance of widely held public firms (e.g., Lehn and Poulsen, 1989; Renneboog et al., 2007) and where the main agency problem is between managers and dispersed shareholders (Jensen and Meckling, 1976). In most other countries, including Continental Western European countries, closely-held firms dominate the economy and the main agency problem is between controlling and minority shareholders (e.g., La Porta et al., 1999; Faccio and Lang, 2002). Our paper advances the existing literature by providing evidence on the role of pre-transaction controlling owners in determining shareholders' wealth gains from GPTs. In particular, it shows that the degree of separation of cash-flow and control rights of the pre-transaction ultimate owners (i.e., excess control) has a first-order effect on these gains.

Second, the present paper adds a new dimension to the growing body of literature on going private by investigating the effect of pre-transaction multiple large shareholders (MLS), as opposed to just one large shareholder, on these gains. Recent studies suggest that MLS can perform a corporate governance role by serving a valuable monitoring function in reducing the diversion of corporate resources (e.g., Maury and Pajuste, 2005; Attig et al., 2008; Laeven and Levine, 2008). However, to our knowledge, no prior studies have been conducted to directly link the presence of MLS to shareholders' wealth gains from GPTs. This paper fills this void by providing evidence on this important, but hitherto unaddressed, issue.

Third, this study presents a new insight into the sources of shareholders' wealth gains from GPTs by focusing on an important, yet underexplored, part of the world namely, Western Europe. Many of the Western European countries have had active going private markets in terms of deal number and value from the mid-1990s onwards (see, for e.g., Geranio and Zanotti, 2012). Moreover, Western European countries provide an excellent laboratory to examine the impact of controlling owners and MLS on shareholders' wealth gains from GPTs since public firms in these countries are characterized by closely held ownership.[2] Besides, controlling owners of Western European public firms have different means whereby they can separate cash-flow rights from control rights (dual class shares, pyramids, etc.), which implies a considerable risk of agency conflicts between controlling and minority shareholders. Furthermore, the presence of MLS is common in many Western European countries. For instance, Laeven and Levine (2008) find that MLS are present in 33.93% of Western European listed firms (at the 10% threshold). Similar results are found by Faccio and Lang (2002).[3]

Our analysis uses data on 314 firms that went private between January 1997 and December 2011 across 18 Western European countries namely, Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden and Switzerland. Apart from few studies (such as Bajo et al., 2013; Croci and Del Giudice, 2014; Martinez and Serve, 2011), existing research on GPTs has mainly focused on leveraged buyouts without paying much attention to deals promoted by existing shareholders (see, for example, Andres et al., 2007; Demiroglu and James, 2010; Officer et al., 2010). In this paper, we use a sample of GPTs that encompasses leveraged and non-leveraged GPTs as well as deals conducted by existing shareholders. The expected shareholder wealth gains from GPTs are measured using cumulative abnormal returns (CARs) and premiums. The different cumulative average abnormal returns associated with the announcements of GPTs range from about 14% to about 22%. Final bidders pay pre-going private shareholders an average raw premium of about 36%. These findings are consistent with the gain-sharing hypothesis.

We find that CARs and premiums are greater when the pre-transaction target firm exhibits a higher separation of cash-flow and control rights of its ultimate owner. We also show that the wealth gains from GPTs decrease with the ownership interests of the pre-transaction ultimate owner. These results indicate that the reduction of costs resulting from agency problems between dominant and small shareholders has an important impact on shareholder gains in Western European GPTs. We also show that the presence of MLS prior to buyouts is associated with lower CARs and premiums. MLS serve a monitoring role in mitigating the pre-going private agency problems between controlling and minority shareholders. Thus, there is less room for operating performance improvements after the buyout. This negative relation is especially strong when the second-largest shareholder prior to going private is a family.

Consistent with recent research, we find that undervalued firms register higher CARs and premiums. This finding is consistent with the view that pre-going private firms are unable to attract investors' interest, which may be due to the adoption by the management of opportunistic behavior. Furthermore, we document evidence that firms with higher free cash flow (FCF) are more likely to register higher premiums, which implies that the pre-going private insiders in these firms are more likely to inefficiently use FCF to extract private benefits of control. We also show that tax incentives and the reduction of pre-going private listing costs do not have an impact on shareholder gains from Western European GPTs.

The remainder of the paper is organized as follows. Section 2 discusses how pre-going private agency costs may affect the sources of shareholder wealth gains from GPTs. Section 3 describes the sample and data. Section 4 explains the methodology. The penultimate section presents the results of the empirical analyses. The ultimate section reviews the central findings and concludes the paper.

2. Do pre-going private agency costs affect expected wealth gains from GPTs?

While previous studies suggest several sources of wealth gains from GPTs (e.g., the reduction of transaction costs, corporate undervaluation, tax savings, etc.), almost no attention has been given to the role of pre-going private agency costs in concentrated ownership settings. In this section, we argue that the separation of cash-flow and control rights of the pre-going private ultimate owner, her ownership interests and the presence of a second large shareholder shape shareholder wealth gains from European GPTs.

2.1. The separation of cash-flow and control rights

US and UK firms feature widely dispersed ownership. However, in most other countries around the world, closely held firms are prevalent and exhibit a separation of cash-flow and control rights of their controlling owners (La Porta et al., 1999). This separation is maintained through pyramiding, dual class shares or cross-holdings (Faccio and Lang, 2002; Claessens et al., 2002).

The effect of the divergence between ownership and control on firm value and performance has received special attention in the

[2] For example, Faccio and Lang (2002) report, using data of 5232 Western European listed firms, that only 36.93% of them are widely held, that is, no single entity or individual controls 20% or more of the voting rights.

[3] Faccio and Lang (2002) show that nearly 31% of firms in Western Europe have at least two large shareholders who hold each more than 20% of the voting rights.