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The impact of corporate governance mechanisms on value increase in leveraged buyouts☆

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Abstract

Using a novel, hand-collected dataset, comprising 321 exited buyouts in the UK in the period 1995 to 2004, this study examines the realized value increase in exited leveraged buyouts. Testing the free cash flow theory, we show that value increase and return characteristics of LBOs are to some extent related to the corporate governance mechanisms resulting from a leveraged buyout, especially managerial equity holdings. We show that return characteristics and the probability of a positive return are mainly related to size of the buyout target and acquisitions carried out during the holding period. Furthermore, we find that the return characteristics between insider driven buyouts and outsider driven buyins are different.
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1. Introduction

Leveraged buyouts have received a substantial amount of attention within the financial research literature (see Jensen, 1993; Thompson and Wright, 1995 for reviews). While there is an extensive evidence of gains in productivity and operating performance, there is a notable lack of research concerning the value increase of buyout targets and returns realized from buyouts at the investment level. Resulting mainly from accessibility of reliable and usually confidential

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transaction data, studies on buyout returns have focused either on limited samples relating to IPOs among the largest transactions rather than across the range of realization options for the buyout market as a whole (see, e.g., Kaplan, 1989) or on fund level measures (see, e.g., Kaplan and Schoar, 2005; Ljungqvist and Richardson, 2003; Cumming and Walz, 2004). This emphasis also parallels research on realizations in the venture capital market which has also tended to consider IPOs (Barry et al., 1990; Das et al., 2003), although an exception is Cumming and MacIntosh (2003). Much existing research has also focused on US studies, primarily covering the first wave of buyouts in the 1980s, yet there may be important legal differences between private equity markets that influence the nature of exit from investments (Cumming et al., 2006). Buyout markets have developed more recently outside the US, notably in the UK and Europe, where contextual conditions have meant that buyout deals have covered a wide size spectrum and that realizations have relied less on IPOs (CMBOR, 2005). Moreover, while there is some recognition that buyouts are heterogeneous with respect to whether they are driven by insiders or outsiders (Lichtenberg and Siegel, 1990; Robbie and Wright, 1995), and with respect to whether they involve the purchase of full firms or divisions (Muscarella and Vetsuypens, 1990), the implications of these differences have not been incorporated into previous studies of value creation and returns. Studies analyzing the factors that impact realized buyout returns at the target company level using a comprehensive sample of different types of buyouts across the full size range and incorporating strategic sales to a third party, secondary buyouts and failures in addition to IPOs can add to the existing literature on leverage buyouts.

According to Jensen's (1986, 1989) free cash flow theory, leveraged buyouts result in corporate governance mechanisms that reduce agency costs and increase firm value through improved operating efficiency. Central elements of this governance structure are debt, ownership of equity and the presence of active investors. Agency costs of free cash flow arise if generated free cash flow is not invested in profitable development and maintenance of the business or distributed to shareholders. Debt can reduce these costs and serve as a substitute for dividends because it creates an obligation to service periodic interest costs. The inability to service these payments and repay the principal will ultimately cause the company to be liquidated. As leverage in buyouts tends to be high, a significant proportion of free cash flow is likely to be committed to servicing the debt. The threat of bankruptcy created by the failure to pay interest motivates organizations to become more efficient. Intensive use of debt to finance a buyout reduces the share of equity in the financing structure, allowing private equity investors and managers to control the majority of stock which they would otherwise be unable or unwilling to undertake. Concentrated ownership provides private equity investors with the ability to monitor and control the strategy of the buyout target firm through an active presence on the board of directors. The need for monitoring management is partially offset by the effective self-monitoring resulting from managerial equity ownership.

Mixed support for Jensen's free cash flow theory has been documented. Lehn and Poulsen (1989), Kaplan (1989), Smith (1990), Muscarella and Vetsuypens (1990), Cotter and Peck (2001) and Bruton et al. (2002) find that increased leverage and realignment of incentives have positive effects on the operating performance of leveraged buyout companies. Additionally, Bull (1989), Hall (1990), Lichtenberg and Siegel (1990), Opler (1992), Long and Ravenscraft (1993), Ofek (1994), Desbrières and Schatt (2002) and Harris et al. (2005) provide evidence of cost cutting and improved margins and efficiency after buyout. Easterwood et al. (1989), Singh (1990), Smith (1990), Long and Ravenscraft (1993) and Holthausen and Larcker (1996) show reductions in capital requirements after a buyout. Halpern et al. (1999), Opler and Titman (1993) for the US and Weir et al. (2005) and Renneboog et al. (2007-this issue) for the UK, however, do not find support for the free cash flow argument as a driver of public to private buyouts.

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