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Financial leverage and bargaining power with suppliers: Evidence from leveraged buyouts ☆

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This paper investigates whether leveraged buyouts (LBOs) increase the bargaining power of firms with their suppliers. We find that suppliers to LBO firms experience significantly negative abnormal returns at the announcements of downstream LBOs. We also find that suppliers who have likely made substantial relationship-specific investments are more negatively affected, both in terms of abnormal stock returns and reduced profit margins, than suppliers of commodity products or transitory suppliers. Interestingly, leveraged recapitalization announcements are not associated with negative returns to suppliers, suggesting that increased leverage without an accompanying change in organizational form does not, on average, lead to price concessions from suppliers.

1. Introduction

The empirical literature on leveraged buyouts (LBOs) documents that these transactions are typically associated with significant improvements in corporate performance, e.g., see Kaplan (1989), Muscarella and Vetsuypens (1990), and Smith (1990). The observed changes in performance are generally attributed to the managerial discipline imposed by dramatic increases in leverage and the improved managerial incentives provided by accompanying changes in organizational form, e.g., see Jensen (1989, 1993). While the changes brought about by LBOs are expected to impact many areas of corporate performance, this paper investigates a somewhat unique aspect of LBOs. Specifically, we examine whether the changes in organizational form and leverage that accompany an LBO impact a firm's ability to bargain with its suppliers.

Theoretical models suggest that increased debt might be one mechanism through, which LBOs can affect bargaining between customers and suppliers. In these models, increased leverage typically serves a positive role in negotiations because it functions as a commitment device. For example, in Bronars and Deere (1991), the required interest payments that result from exchanging debt

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for equity allow a firm to limit the revenues that suppliers can extract without forcing the firm into costly bankruptcy. Similarly, increased leverage may enable a firm to credibly threaten to forgo an investment that would enhance a supplier's claim unless the supplier agrees to price concessions (Perotti and Spier, 1993; Subramaniam, 1996).

LBOs not only dramatically increase leverage, but typically also significantly alter corporate governance characteristics. For example, Denis (1994) describes how Safeway's LBO was accompanied by dramatic changes in managerial ownership, board composition, executive compensation, and outside investor monitoring. The accompanying changes in governance and incentives may prompt managers to take full advantage of the improved bargaining power conferred on their firms by high leverage. In other words, improved managerial incentives may serve as the carrot that prompts managers to press as hard as possible in negotiations and debt service commitments may serve as the stick that managers use to induce suppliers to grant price concessions. We refer to the idea that an LBO creates an opportunity for a firm to extract concessions from its suppliers as the *bargaining power hypothesis*.

There is anecdotal support for the bargaining power hypothesis. For example, Anders (1992) quotes Safeway's chief financial officer Harry Sunderland as commenting, "Only the radical surgery of the buyout and restructuring could give us the negotiating strength and resolve to rescue our core business from the insatiable appetite of the unions," following the company's 1986 LBO. Baker and Wruck (1989) describe how O.M. Scott & Sons Company extracted concessions from its corporate suppliers after its LBO. Scott managers felt that the increase in leverage strengthened their bargaining position with suppliers as the suppliers understood Scott might default if the suppliers did not capitulate on terms. Similarly, following an LBO, supermarket chain Buttrey Food & Drugs undertook a comprehensive review of its suppliers with a goal of "raising funds to help defray the costs of the LBO." According to Buttrey president Ed Agnew, "What we are doing is inviting each vendor in to update them on the circumstances of our LBO and to discuss his terms and conditions." (See Elliot Zwiebach, "Buttrey is Stressing Products that Come with better Terms; Supermarket Chain is Looking for Better Deals From Suppliers," Supermarket News, November 5, 1990.)

To determine whether these anecdotes are consistent with results from a larger sample, we identify 221 firms that were suppliers to 699 firms that proposed LBOs and leveraged recapitalizations (recaps), transactions that we jointly refer to as highly leveraged transactions (HLTs). Due to the lack of observable prices for transactions between suppliers and customers, we infer the effects of leverage changes on the terms of trade from the trading partners' stock returns around the LBO announcements and subsequent changes in reported profit margins. We document that suppliers to LBO firms experience an average abnormal return of −1.36% (t=−2.40) upon announcement of the downstream LBOs (results for suppliers to recap firms are described below). The negative returns to suppliers contrast with an average 18.58% (t=24.56) abnormal return to the LBO firms, suggesting that the market considers these deals good news for the shareholders of the companies undertaking them, but bad news for the shareholders of the companies' suppliers.

Under the bargaining power hypothesis, those suppliers that have made significant relationship-specific investments should be particularly susceptible to their customers adopting a tougher bargaining stance as in Klein et al. (1978). Thus, we develop an algorithm to characterize supplier relationships with the LBO firms as either "specific" or "nonspecific" using information disclosed in supplier firms' filings with the U.S. Securities and Exchange Commission (SEC) and media accounts of the supply relationships. We find that firms classified as specific suppliers have significantly more negative announcement period abnormal stock returns than firms classified as nonspecific. Stock returns are also more negative for suppliers identified as more dependent using a measure based on the fraction of a supplier's total sales that are made to a particular customer and the length of relationship with that customer.

Post-LBO changes in operating performance are also consistent with changes in relative bargaining power. LBO firms significantly reduce their costs of goods sold and increase their operating income margins. Supplier firms' operating margins generally decline following the completion of a downstream LBO and, perhaps not surprisingly, these declines are most apparent (in both a statistical and economic sense) for those suppliers that have likely made relationship-specific investments.

In addition to the bargaining power effect, an LBO firm's relationship with its suppliers could also change if the LBO firm reduces output or eliminates a line of business and, hence, reduces the derived demand for inputs, e.g., see Kovenock and Phillips (1995). Demand for inputs may also decrease in the event of financial distress at the LBO firm. We refer to these possibilities jointly as the *reduced demand hypothesis*. The reduced demand and bargaining power hypotheses are not mutually exclusive and both predict that an LBO will harm suppliers. However, we do not find any convincing evidence that the reported supplier-firm negative abnormal returns are driven by reduced demand.

In summary, our results suggest that LBOs enhance firms' bargaining power with their suppliers. These transactions result in significantly negative supplier announcement returns that do not appear to result from reduced demand for the supplier's product or service. The profit margins of suppliers who made relationship-specific investments shrink following their customers' LBOs. Finally, cost of goods sold decrease and profit margins increase for the LBO firms.

Contrasting the impact of LBOs and leveraged recapitalizations on suppliers can potentially allow us to gauge the relative importance of changes in organizational form on bargaining power. Recaps and LBOs substantially increase debt levels, but recaps are not typically associated with the extensive governance changes that accompany LBOs. By definition, recap firms continue to have publicly traded equity outstanding following the transactions, but this is only the most obvious difference. LBO-firm investors also generally take a very active role on the board of directors. Denis (1994) reports that following its 1988 recap Kroger did not initiate the dramatic governance changes seen with Safeway's LBO. Further, Denis and Denis (1993) report that median director and officer ownership increases from 1.7% pre-recap to 3.6% post-recap for a sample of completed leveraged recapitalizations whereas Kaplan (1989) reports that median director, officer, and buyout specialist ownership increases from 5.88% pre-LBO to 99.0% post-LBO for a sample of leveraged buyouts.

Interestingly, for our sample, the effects of LBOs and recaps on suppliers appear to be quite divergent. Suppliers to recap firms experience an average abnormal return of 0.73% (t=0.92) at announcement compared with the −1.36% average return for suppliers