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Club deals in leveraged buyouts ☆

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ABSTRACT

We analyze the pricing and characteristics of club deal leveraged buyouts (LBOs)—those in which two or more private equity partnerships jointly conduct an LBO. Using a comprehensive sample of completed LBOs of U.S. publicly traded targets conducted by prominent private equity firms, we find that target shareholders receive approximately 10% less of pre-bid firm equity value, or roughly 40% lower premiums, in club deals compared to sole-sponsored LBOs. This result is concentrated before 2006 and in target firms with low institutional ownership. These results are robust to controls for target and deal characteristics, including size, *Q*, measures of risk, and time and industry fixed effects. We find little support for benign motivations for club deals based on capital constraints, diversification motives, or the ability of clubs to obtain favorable debt amounts or prices, but it is possible that the lower pricing of club deals is an inadvertent byproduct of an unobserved benign motivation for club formation.

1. Introduction

Following the leveraged buyout (LBO) boom of the 1980s and the relatively quiet 1990s, LBO activity again boomed in the 2001–2007 period before collapsing in 2008. Total LBO deal volume in the United States alone rose from approximately $30 billion in 2001 to over $450 billion in 2007 (Thomson Financial M&A Review, 2007). Kaplan and Strömberg (2009) report that total equity capital commitments to U.S. private equity funds reached $228.0 billion in 2007, or 1.57% of total U.S. stock market capitalization.[1]

This sharp increase in private equity activity has reignited the debate among economists and policymakers regarding the efficiency and welfare implications of LBOs. Proponents of the private equity/LBO model stress the potential for creating value in target firms through operating improvements, reduced agency costs of free

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[1] We use the terms LBO and private equity sponsored deal interchangeably, as do Kaplan and Strömberg (2009). Some authors also refer to these as "going private transactions" or management buyouts (MBOs). In this paper we focus on buyouts of publicly traded targets in deals sponsored by prominent private equity firms. These deals almost universally involve large amounts of leverage and also frequently involve the target's pre-deal executive management team. Therefore, we consider all these terms to be practically identical in describing the types of transactions that we are interested in.

cash flow, and stronger managerial incentives (Jensen, 1986). Skeptics suggest that the large profits earned by some private equity partnerships may be partly due to expropriation of target shareholders and stakeholders, or private equity investors, rather than bona fide efficiency improvements (Perry and Williams, 1994; Phalippou, 2009). Other criticisms of LBOs in the 1980s and the 2001–2007 period are that private equity firm profits stem in part from taking advantage of the tax deductibility of interest payments and/or inefficient bond markets in which credit spreads are occasionally excessively low.

Recently, particular criticism has been directed at the so-called club deals, in which two or more private equity firms jointly sponsor an LBO. Clearly, one concern about club deals is that private equity partnerships may be colluding to depress prices by limiting the number of competing bidders in an auction for a takeover target, and thereby may be shortchanging passive, dispersed shareholders of target publicly traded corporations. This concern has strong grounding in the auction literature, in which it is well-recognized that bidder collusion may depress sale prices (e.g., Graham and Marshall, 1989; Marquez and Singh, 2009), and in the regulatory economics literature (e.g., Cramton and Schwartz, 2000; Hendricks and Porter, 1992). These literatures stress that collusion can reduce prices even in the absence of repeat play and even if collusion does not involve all potential bidders for a target. Another, more innocuous, concern is that the limited number of private equity firms interested in a given target may mean that clubbing, even when done in the absence of collusion and for benign reasons, may lead to a reduction in bid competition and hence to lower premiums for target shareholders.

In the absence of an instrumental variable for club formation, it is, of course, not possible to conclusively prove any causal effect of club deals on premiums paid to target shareholders (Bailey, 2007). Even if such an instrument were available, it is also impossible to explicitly distinguish between deliberate collusion to reduce prices and inadvertent reduction in bid competition resulting from the limited number of private equity firms interested in any given target, because intent is unobservable. Nor is it possible to conclusively prove whether club deals result in increased or decreased social welfare.

That said, it is possible to explore the association between club deals and premiums paid to target shareholders, how this association varies in the time-series and cross-section, whether there exist differences in observable characteristics between target firms in club deals and those in other types of deals, and also to consider possible interpretations to advance our understanding of club deals. It is also possible to investigate whether any differences in premiums paid in club deals relative to other types of deals are likely to be due to characteristics suggested by many of the classic theories of deal syndication.

The classic theories of deal syndication suggest a number of benign reasons, unrelated to competition, for why private equity firms may syndicate deals by forming clubs. Capital constraints may induce the formation of clubs for sufficiently large transactions. Even if capital constraints do not bind, diversification motives may induce funds to syndicate sufficiently large or risky deals. Club deals may also be motivated by a desire to certify deal quality to debt financiers. LBOs are highly levered, and it may be easier to acquire debt financing in sufficient quantity and on favorable terms if multiple private equity firms attach their names and reputations to a deal.

In this paper we provide evidence on these explanations for, and concerns about, club deals in leveraged buyouts by examining the pricing and characteristics of club deals relative to sole-sponsored LBOs and to other merger and acquisition (M&A) transactions. In doing so, we add to the evidence on the differential pricing and characteristics of acquisitions conducted by private equity firms compared to those conducted by other types of acquirers (Bargeron, Schlingemann, Stulz, and Zutter, 2008). Concerns about club deals in the press, and elsewhere, are naturally focused on prominent (or large) private equity firms, because minor private equity firms are less likely to have the market power to meaningfully reduce competition and therefore prices (inadvertently or otherwise) by forming clubs. Accordingly, we conduct our analysis using a comprehensive sample of completed LBOs of U.S. publicly traded targets conducted by prominent private equity firms between January 1984 and September 2007.[2]

Our main finding is that target shareholders in club deals receive significantly lower premiums than in sole-sponsored LBOs and other merger and acquisition transactions. The differences are economically large: target shareholders receive approximately 10% less of pre-bid firm equity value, or roughly 40% lower premiums, in club deals compared to sole-sponsored LBOs.[3] These results are robust to controls for target and deal characteristics, including size, *Q*, measures of risk, and time and industry fixed effects. The results are also robust to private equity firm fixed effects, indicating that, even though the tendency to club together is concentrated amongst a few prominent private equity firms, our results are not driven by the ability of a few private equity partnerships to pay low prices regardless of whether they act alone or as part of a club. Our results also hold in regression and matching analyses using an LBO-only sample.

This club deal discount is concentrated in club deals announced *prior* to 2006; the financial media began expressing concerns about club deals at the end of 2005 and the U.S. Department of Justice started an informal inquiry into the practice in 2006.[4] In fact, the club deal

[2] We define prominent private equity firms as the largest 50 firms by worldwide fundraising over 2002–2007, as well as the private equity arms of major investment banks, and private equity firms that were prominent in the 1980s but are now defunct. We describe the sample in detail in Section 3.

[3] Depending on the premium measure, time period, and estimation technique, our estimates of the club deal discount range from 5% to 24% of pre-bid target equity or firm value, with most estimates in the range of 8–12%.

[4] See Andrew Sorkin, *New York Times*, October 16, 2005, and "Private equity firms face anticompetitive probe," *The Wall Street Journal*, October 10, 2006. A competing explanation for this structural break is the increased inflow of funds to the private equity industry around the same time, but we do not find supporting evidence for this. Even so, it is, of course, not possible to conclusively attribute any structural break in time to a specific event with time-series evidence alone.