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The performance of reverse leveraged buyouts ☆

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ABSTRACT

Reverse leveraged buyouts (RLBOs) have received increased public scrutiny but attracted little systematic study. We collect a comprehensive sample of 526 RLBOs between 1981 and 2003 and examine the three-year and five-year stock performance of these offerings. RLBOs appear to perform as well as or better than other initial public offerings and the stock market as a whole, depending on the specification. Evidence exists of a deterioration of returns over time.

1. Introduction

In recent years, intense public scrutiny has surrounded the phenomenon of reverse leveraged buyouts (RLBOs), or initial public offerings (IPOs) of firms that had previously been bought out by professional later-stage private equity investors. This paper seeks to understand the long-run performance of these offerings, to address whether these concerns are justified.

To date, much of the discussion of these offerings focuses on a few troubled RLBOs, such as Refco, which Thomas H. Lee Partners bought a majority stake in for more than $500 million in 2004 and took public at more than double the price a year later. In one of the more than a dozen lawsuits filed after the collapse of the firm soon after its IPO, the plaintiffs asserted that "there are substantial questions to be answered concerning the structure, cost and effects of the investment in Refco by Thomas H. Lee Partners in June of 2004, and Refco's IPO in August of 2005".[1]

More generally, observers argue that buyout groups push overleveraged companies too quickly into the public market. For instance, the New York Times (2005) observed:

> [S]everal high-profile quick flips have left critics wondering whether buyout firms were using such offerings simply to line their pockets, rather than using the proceeds to support companies. Earlier [in 2005], the Blackstone Group sold a German chemicals company, the Celanese Corporation, to the public after owning it for less than 12 months. The firm quadrupled its money and all of the proceeds from the offering

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[1] http://lbo.djnewsletters.com/exclusives.asp?s=DEALBOOK&sid=NIQPOPOQMHI (accessed May 22, 2006).

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> were used to pay out a special dividend to Blackstone. Mr. Kravis's firm, Kohlberg Kravis Roberts & Company, also quadrupled its money by flipping PanAmSat, the satellite company it owned for less than a year.

A *Wall Street Journal* (2006) article on RLBOs noted that "while some debt is fine, when it is taken on to finance things that only benefit some shareholders—such as special dividends—new investors are buying hobbled companies".

But it is plausible to wonder whether buyout groups would find such a strategy productive. Buyout groups typically hold large equity stakes in firms prior to their IPOs, and they continue to retain substantial holdings subsequent to the offerings. Thus, the post-IPO long-run performance of RLBOs have substantial wealth implications for the private equity investors. More important, as repeat players in the IPO market, buyout groups suffer reputation losses if their RLBOs turn out to be failures.

These discussions suggest the desirability of a systematic look at the long-run performance of RLBOs. Surprisingly, these offerings have attracted little attention in the academic literature in recent years, despite the considerable attention devoted to the performance of venture capital-backed IPOs (Brav and Gompers, 1997; Gompers and Lerner, 1999; Hamao, Packer, and Ritter, 2000; Jain and Kini, 2000; Masulis and Li, 2005; and many others).

Several papers in the earlier literature, however, are relevant to this one. First, there is a literature on the evolution of leveraged buyouts (LBOs). Kaplan (1991) examines 183 large leveraged buyouts executed between 1979 and 1986, showing that a significant fraction of firms undergoing LBOs went public once again. The RLBOs in his sample remained private for a median time of 6.82 years. Muscarella and Vetsuypens (1990) examine 72 RLBOs between 1983 and 1987. They find substantial increases in profitability and temporary increases in leverage when compared with the same firms prior to the LBO.

Most relevant are four studies. Degeorge and Zeckhauser (1993), examining 62 RLBOs between 1983 and 1987 (though much of the analysis is based on a smaller sample), find that the accounting performance of these firms exceeds their peers prior to going public and then deteriorates thereafter. They find no evidence, however, that these offerings' stock returns underperform the market. Holthausen and Larcker (1996) examine 90 RLBOs between 1983 and 1988, and they argue that there is no evidence of poor performance when either accounting or stock market measures are employed. Chou, Gombola, and Liu (2006) study earnings management around RLBOs and find positive and significant discretionary current accruals coincident with RLBOs. Finally, Mian and Rosenfeld (1993) examine 85 RLBOs over roughly the same period and find that the offerings slightly outperform their stock market peers.

The absence of scrutiny of RLBOs since the 1980s is especially striking due to the changes in the market. The buyout market of the 1990s and 2000s is very different from that of the 1980s, both in terms of the amount of capital deployed and the degree of competitiveness of these transactions. It is natural to ask whether the earlier patterns still characterize this market.

This analysis also provides an opportunity to understand the drivers of cross-sectional differences in RLBO performance. The modest number of offerings studied limits the ability of earlier authors to draw systematic conclusions about the considerations that made RLBOs particularly successful.

In this paper, we examine 526 RLBOs between 1981 and 2003. The following conclusions emerge from the analysis:

- In cross-sectional analyses, RLBOs appear to consistently outperform other IPOs and the market as a whole.
- In the calendar-time portfolio, the performance of RLBOs does not significantly differ from the market.
- The performance of RLBOs appears to have deteriorated in more recent years, but RLBOs backed by larger buyout sponsors performed better in recent years.
- No evidence exists that more leveraged RLBOs perform more poorly than their peers.

The plan of this paper is as follows. Section 2 briefly reviews the evolution of the leveraged buyout market since the 1980s. In Section 3, we discuss the construction of the data set employed in the study. Section 4 presents the basic analyses of long-run performance. Supplemental analyses examining cross-sectional differences in RLBO returns are discussed in Section 5. The final section concludes the paper.

2. The evolution of the leveraged buyout market

During the 1980s, the US buyout industry was made up of a relatively small number of organizations. These groups identified transactions through personal contacts with executives in key industries and various intermediaries. When they identified a transaction, they would often have weeks or months to analyze the proposed deal. They would then structure the transaction using high degrees of leverage. Often as much as 85% or 90% of the total purchase price would be in the form of debt. As a result, even a modest increase in the value of the firm, which could be due to the overall growth in the stock market, inflation, or operating improvements, would lead to substantial profits for the equity-holders.

As Kaplan (1997) notes:

> In the first half of the 1980s, the LBO insights led to great success. As documented in Kaplan (1989) and Kaplan and Stein (1993), buyout companies experienced improved operating profits and few defaults. Adjusting for the overall stock market or industry, these early buyouts generated abnormally positive returns. Because the overall stock market increased over this period, buyout sponsors earned substantial nominal returns.

Subsequent years were more challenging for buyout groups. The buyout industry today is far larger than it was