



# The effect of change-in-control covenants on takeovers: Evidence from leveraged buyouts

Matthew T. Billett<sup>a</sup>, Zhan Jiang<sup>b</sup>, Erik Lie<sup>a,\*</sup>

<sup>a</sup> Henry B. Tippie College of Business, University of Iowa, Iowa City, IA, 52242-1994, United States

<sup>b</sup> Department of Finance and Managerial Economics, School of Management, University at Buffalo 344 Jacobs Management Center, Buffalo, NY 14260-4000, United States

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## ABSTRACT

Change-in-control covenants first became commonplace towards the end of the takeover wave in the 1980s. We examine merger and acquisition activity from 1991 to 2006 to see how such covenant protection influences the wealth effects and probability of takeovers. Examining a sample of leveraged buyouts (LBOs) we find bondholders with such covenant protection experience average wealth effects of 2.30% while unprotected bonds experience  $-6.76\%$  upon the announcement of an LBO. Furthermore, we document that the existence of bondholder change-in-control covenants cuts the firm's probability of being targeted in an LBO in half. We also find that change-in-control covenants reduce the probability of being targeted in non-LBO takeovers, but the effect appears less dramatic.

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## 1. Introduction

Change-in-control (CIC) covenants proliferated in response to the hostile takeover wave of the late 1980s. They were hoped to be particularly effective in deterring the negative wealth effects of LBOs (Warga and Welch, 1993). Crabbe (1991) and Cook and Easterwood (1994) examine the yield spreads and the wealth effects of issuing bonds with such protection. While their evidence is consistent with the notion that CIC covenants effectively deter LBOs, little direct evidence exists. We fill this gap in the literature by examining the effect of CIC covenants on takeover activity during the period from 1980 through 2006, which includes two recent LBO takeover waves as well as one in the 1980s.

We explore the influence of CIC covenants in two ways. First, we examine whether CIC covenants indeed protect bondholders in the event of an LBO. If CIC covenants are effective, we expect less negative bond returns around LBOs for bonds with CIC covenants. Second, we examine whether CIC covenants deter LBOs in the first place. If CIC covenants are effective in protecting bondholders and private equity firms view expropriation of wealth from bondholders as an important source of gains in LBOs, then we would expect CIC covenants to lower the probability a firm will be targeted for an LBO.

We find that, like the experience documented for the 1980s by Warga and Welch (1993), bondholders suffer negative wealth effects to LBOs. The mean abnormal return across all bond issues in our sample is  $-4.9\%$ , statistically different from zero. However, this mean masks significant cross-sectional variation attributable to CIC covenants. For the sub sample of bonds without CIC protection, the mean abnormal return is  $-6.8\%$ . In contrast, the mean for bonds with CIC covenant protection is  $2.3\%$ . The difference between the two samples of  $-9.1\%$  is significant at the 1% level. On this basis, the covenant protection seems highly effective in protecting bondholders against expropriation, and might actually lead to bondholder gains in these transactions, as they typically receive 101% of face value plus accrued interest.

\* Corresponding author.

E-mail addresses: [matt-billett@uiowa.edu](mailto:matt-billett@uiowa.edu) (M.T. Billett), [zjiang5@buffalo.edu](mailto:zjiang5@buffalo.edu) (Z. Jiang), [erik-lie@uiowa.edu](mailto:erik-lie@uiowa.edu) (E. Lie).

As noted earlier, if private equity firms view expropriation of wealth from bondholders as a source of gain in LBOs and covenant protection mitigates such expropriation, we would expect LBO targets to have a lower incidence of CIC protection. Indeed, among our sample of LBO targets during the recent wave, 41% have change-in-control covenants, compared to 57% for a sample of non-LBO control firms. This difference of 16% is statistically different from zero. We next estimate a logit regression of the probability of being an LBO target. After controlling for other determinants, we find that firms without change-in-control covenants are twice as likely to be targeted as firms without such covenants. We also find that the probability of other types of takeovers (non-LBO acquisitions and mergers) is negatively related to the presence of covenant protections, though the relation is weaker than it is for LBOs. Billett et al. (2004) find that bondholders typically do not suffer in regular takeovers, and often gain. Nevertheless, protective covenants also seem to deter regular takeovers, because bondholders might exercise their right to be paid off even if they are not necessarily worse off from the transaction.

To look at the influence of CIC covenants, we also need to identify and control for other changes in the private equity market and the structure of deals that might have occurred. For example, LBO deals in the 1980s stereotypically involved hostile bids financed by massive debt loads. Targeted firms in this wave of LBOs tended to be high cash producers with significant room for operating/management improvement (Opler and Titman, 1993). Anecdotal evidence regarding the more recent wave of private equity deals suggests that some of their characteristics have changed. The recent wave does not appear to be associated with hostile raiders and embittered target managers. A *Wall Street Journal* article dated 1/3/2007 comparing the eighties to the recent LBO wave states “Perhaps the most surprising change? KKR is no longer the ‘barbarian at the gate’”, suggesting management is much less resistant to LBO inquiries. While LBOs still rely heavily on junk bond financing, they appear to use less of it. In the same article George Roberts, of the private equity firm KKR, states that deals in the 1980s were financed with 93% debt and 7% equity, compared to current deals which are 67% debt and 33% equity. Perhaps this is not surprising given that around 27% of the debt issues associated with LBOs in the late 1980s ended up in default (Kaplan and Stein, 1993).

Along these lines we document that relative to the 1980s, the more recent LBO wave is characterized by less bidder competition, proportionally fewer hostile deals, and smaller toeholds. Like Opler and Titman (1993), we document that LBO firms in the 1980s had high cash flow and low market-to-book (M/B) ratio. We further find that LBO firms in the recent decade exhibit similar tendencies, although the standard deviations of cash flow, M/B ratio and other firm characteristics suggest a much greater assortment of firms undergo LBOs in the recent wave. These results suggest that LBO targets during both periods were plagued by overinvestment problems, and mitigating these problems via higher leverage is an important motivation.

The rest of the paper proceeds as follows. The next section reviews related literature. Section 3 describes our sample. Section 4 discusses empirical results. Finally, Section 5 summarizes and concludes.

## 2. Literature review

Public ownership is traditionally viewed as an efficient mechanism for providing access to the capital market and promoting better management. With a surge of leveraged buyouts in the 1980s, the weakness of public corporations became apparent. Jensen (1989) suggests that the public company had outlived its usefulness and the emergence of private equity provides a new and powerful model of management. The natural question is: What is the source of wealth gain in going-private transactions?

Kaplan (1989a) focuses on tax benefits as the source of wealth gains in LBOs in the 1980s. He estimates the tax benefits to be between 21% and 72% of the premium paid to the target firm shareholders. However, it is unlikely that tax shields alone motivate LBOs, because firms took on more debt than was necessary to eliminate their taxable earnings (Opler, 1992). Lehn and Poulsen (1989) argue that LBOs are motivated by the gains from realigning incentive problems, particularly those associated with free cash flow. In support of this argument, they find that firms with high free cash flow are more likely to go private. Similarly, Opler and Titman (1993) find that firms with high cash flow and low Tobin's  $q$  are more likely to become LBO targets, suggesting that LBOs are used to curb overinvestment arising from free cash flow. Furthermore, Kaplan (1989b) reports a significant increase in operating performance following going-private transactions, which he attributes to better incentive alignment between executives and shareholders.

The discussion above suggests that the gains to private acquirers in LBOs stem from various types of synergies that enhance the total value of the LBO target. Shleifer and Summers (1988) conjecture instead that the gains to private acquirers come at the expense of pre-buyout bondholders. Consistent with this conjecture, several studies, including Asquith and Wizman (1990), Cornett and Travlos (1993), and Warga and Welch (1993), document a statistically significant bondholder loss upon LBO announcements in the 1980s. For example, Warga and Welch report that pre-existing target bondholders suffered significant losses averaging approximately 7%.<sup>1</sup>

There are also studies that examine bondholder wealth effects in mergers and acquisitions in general. Billett et al. (2004) examine the wealth effects to target bondholders in transactions that involve both a publicly traded target and acquirer. They document that target bondholders gain 1.09% on average. They further show that target bondholder gains are much larger when

<sup>1</sup> There is also evidence that bondholders do not suffer in LBOs. Marais et al. (1989) examine the abnormal returns to 33 bond issues for LBO transactions from 1974 to 1985. They find the average abnormal return for these straight bonds is negative, but very close to zero ( $-0.00$  is the reported figure) and statistically insignificant. However, the data they use might not be as informative as that used by Warga and Welch (1993). Marais et al. (1989) use bond prices from the *Wall Street Journal* and compute abnormal returns by subtracting the overall Dow Jones Bond Index. As noted by Warga and Welch, the *Wall Street Journal* reported prices come from the NYSE. The bond trades on the NYSE are typically small trades by individual investors. The more liquid market is between large dealers. Thus, using prices from Lehman Brothers, the largest dealer in corporate bonds at the time, Warga and Welch find the average abnormal return (computed using a rating and maturity matched index) is far more negative than that documented in prior studies.

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