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Private equity, leveraged buyouts and governance ☆

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Abstract

This paper provides an overview of the literature on private equity and leveraged buyouts, focusing on global evidence related to both governance and returns to private equity and leveraged buyouts. We distinguish between financial and real returns to this activity, where the latter refers to productivity and broader performance measures. We also outline a research agenda on this topic.

JEL classification: G34; G32
Keywords: Management buyouts; Private equity; Total factor productivity; Financial and real returns; Corporate governance

1. Introduction

The recent resurgence of leveraged buyouts (henceforth, LBOs) and the concomitant rise of "private equity" markets in the U.S. and internationally, has been accompanied by renewed concerns about their effects (e.g. Financial Services Authority, 2006). These concerns emphasize a need to evaluate the impact of these transactions on organizations and society. Researchers

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typically assess the impact of such changes in ownership on firm performance by examining effects on short-run stock prices ("event studies"), long-run stock prices, returns to investors, or accounting profits of publicly-traded firms.[3] This approach provides evidence on the firm-level, financial "returns" to buyouts.

On the other hand, there is considerable interest in assessing the broader impacts of buyouts and private equity. Policy decisions regarding the optimal level of buyout activity hinge mainly on their impact on economic efficiency (i.e., the "real" returns to buyouts), not on their effects on share prices or profitability (i.e., the "private" or firm level returns to buyouts). For instance, a critical policy issue concerning LBOs is whether they enhance economic efficiency. This paper reviews recent global evidence on governance and the financial and real returns to buyouts and private equity, and outlines a research agenda on this topic. In our review of the literature we discuss data limitations that have plagued efforts to analyze governance and the financial and real returns (impacts on productivity and broader performance measures) to private equity and buyout investments. To this end, we also provide an overview of the articles in this special issue, which improve our theoretical and empirical understanding of private equity, leveraged buyouts and governance. The papers in this special issue fit within three broad themes: (1) the impact of governance on leveraged buyouts returns (Nikoskelainen and Wright; Cressy et al.) and the returns to VC-led PIPEs (Dai), (2) governance in private placements (Barclay et al. and Arena and Ferris) and public to private transactions (Renneboog et al.), and (3) the determinants of governance structures in venture capital and private equity (Bernile et al.) and turnaround transactions (Cuny and Talmor). We discuss this research and provide a broad overview of related issues in this paper.

2. Financial vs. real returns to management buyouts

2.1. Financial performance of buyouts and private equity

Table 1 presents the salient characteristics of recent studies of the financial returns to LBOs. Early studies, based on share price (e.g. Kaplan, 1989; Lehn and Poulsen, 1989; Marais et al., 1989) and accounting data (e.g. Kaplan, 1989; Smith, 1990; Smart and Waldfogel, 1994), all strongly suggest that buyouts enhance financial performance. The studies summarized in Table 1 have been published since 1995 and cover both the U.S. and various European countries. Some studies consider LBOs as a homogeneous group while other studies distinguish between insider driven management buyouts (MBOs) and outsider driven management buyins (MBIs). These transactions may involve the taking private of whole listed corporations (public to private buyouts, PTPs), or buyouts involving divisions of corporations or whole private firms. In general, the studies show, using both shareholder returns data and accounting returns, and from both the level of different types of buyout and the private equity fund level, that buyouts generate significant financial returns. In the remainder of this section, we discuss these recent findings in more detail. We distinguish where studies are referring to different types of buyout.

2.1.1. Returns to shareholders

Renneboog et al. (2007-this issue) examine the magnitude and the sources of the expected shareholder gains in U.K. public to private buyout transactions (PTPs) in the second wave of buyouts from 1997–2003. These authors find that, on average, pre-transaction shareholders reap a

[3] See Kaplan (1989) and Jensen (1993).