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Leveraged Buyouts: Motives and Sources of Value

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ABSTRACT

This paper provides an exhaustive literature review of the motives for public-to-private LBO transactions. First, the paper develops the theoretical framework for the potential sources of value creation from going private: a distinction is made between the reduction in agency costs, stakeholder wealth transfers, tax benefits, transaction costs savings, takeover defense strategies, and corporate undervaluation. The paper then reviews and summarizes whether and how these theories have been empirically verified in the four different strands of literature in LBO research. These strands of literature are categorized by phase in the LBO transaction: Intent (of a buyout), Impact (of the LBO on the various stakeholders), Process (of restructuring after the leveraged buyout) and Duration (of retaining the private status). Then, the paper shows that in the first half of the 2000s, a public-to-private LBO wave re-emerged in the US, UK and Continental Europe, whose value vastly exceeded that of the 1980s US LBO wave. Finally, the paper provides suggestions for further research.

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1

Introduction

The publicly listed corporation is often believed to have important advantages over its private counterpart. A stock market listing enables firms to raise funds in equity markets, increases the share liquidity for investors, allows founders and entrepreneurs to diversify their wealth, and enables the use of stocks and options in remuneration packages. Also, the higher degree of visibility and media exposure of public firms can be an effective tool in the marketing of the company. On the personal level, founders and managers of public corporations generally enjoy more prestige. However, a publicly listed company with dispersed ownership may suffer from too high a degree of managerial discretion resulting from a lack of monitoring which may lead to 'empire building' at the detriment of shareholder value. One way of refocusing the management's attention on shareholder value creation is the leveraged buyout (LBO), in which an acquirer takes control of the firm in a transaction financed largely by funds borrowed against the target's assets and/or cash flows.

This type of transaction - labelled 'bootstrapping acquisition' (Gilhully, 1999) during its infancy in the 1960s - was aggressively promoted in the 1970s by Wall Street practitioners such as Jerome Kohlberg, Jr. During the 1980s, LBOs grew substantially in the US, and gradually spilled over to the UK. Between 1979 and 1989, the market capitalization of public-to-private (PTP) transactions in the US alone was in excess of $250 billion (Opler and Titman, 1993). This PTP trend was not just limited to the smaller public companies. For instance, in 1989, the LBO-boutique Kohlberg, Kravis and Roberts (KKR) took over and delisted RJR Nabisco in a deal valued at $25 billion. Apparently, executives, financiers and investors regarded the private firm as a strong alternative to the public corporation such that some even predicted the "eclipse of the public corporation" (Jensen, 1989, p. 61).

The potential sources of wealth gains from PTP transactions have been a focal point of academic research. While the critics of going-private transactions have continuously emphasized tax advantages and the expropriation of non-equity stakeholders as the main sources of wealth gains from going private, systematic research on PTP transactions does not agree. Other potential sources of wealth gains are a stronger incentive alignment with a focus on performance and value, the reduction in wasting corporate resources, and improved monitoring capabilities embedded in the governance structure of an LBO. In addition, going private eliminates the costs associated with maintaining a stock market listing, but may also be motivated by a defensive strategy against hostile takeovers. Finally, going private may simply constitute a monetization of an undervalued asset.

The beginning of the 2000s saw a new wave of PTP transactions in the US, UK, and Continental Europe, fueled by cheap debt in the collateralized debt obligation (CDO) markets. Despite vastly exceeding the 1980s' LBO wave in value, this wave came to a halt with the demise of the securitized debt markets at the end of 2007.

The strong increase in the number of deals and average deal value and the fact that past LBO research was limited in scope (given the focus on the US and on the 1980s) call for further research. To facilitate the development of a new research agenda, we analyze the motives for taking public firms private and provide a structured and critical review of the empirical research in this area. We examine which types of firms go private as well as the determinants of takeover premiums in LBO transactions. We also investigate whether the post-transaction value creation as well as the duration of the private status can be explained by the above mentioned potential value drivers. We answer the questions whether or not PTP transactions lead to superior organizational forms compared to public firms, and whether going private is a shock therapy to restructure firms, which generates both strong short- and long-term returns. Finally, the paper documents the trends and drivers of global LBO activity in the 1980s, 1990s, and the subsequent decades.

The paper is organized as follows. Section 3.2 briefly discusses on the different types of leveraged buyouts and going-private transactions. Section 3.3 discusses the theoretical considerations underlying the sources of wealth gains from going private deals. Section 3.4 focuses on the four main strands of the literature (namely, on the Intent to do an LBO, on the Impact of the LBO measured by changes in the share price returns, on the LBO Process or on how the firm is restructured in the post-LBO stage, and on the Duration of being a private firm) and on the empirical evidence supporting the eight motives proposed by each strand of the literature. Section 3.5 explains the drivers behind the observed LBO waves that emerged over the past 35 years. Section 3.6 lines out a future research agenda.

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