

The Determinants of Buyout Returns: Does Transaction Strategy Matter?

Robert P. Bartlett, III^a and Annette B. Poulsen^b

This paper reexamines one of the most studied questions in the scholarship of leveraged buyouts (LBOs): how do LBO sponsors create value for their investors in take-private acquisitions? For more than twenty-five years, judges, regulators and academics have sought to understand how LBO sponsors create their significant investment returns, particularly in the context of a going-private transaction in which an LBO firm—often in conjunction with a company’s management—buys out the shareholders of a publicly-traded company only to later sell the company back to the public markets (via an IPO) or to a strategic buyer at a higher valuation. The potential conflict of interest between a target managers’ fiduciary duty to maximize the sale value of the target company and their financial interest in profiting in a successful LBO has understandably created concern that target managers might be selling to favored LBO sponsors on the cheap.

Beginning in the late 1980s, however, a large body of finance scholarship emerged that provided both a theoretical and empirical account of how LBOs create value for their investors independently of the price paid for a target. In particular, Jensen’s (1989) account of the agency costs associated with public equity provided a coherent theory of how the LBO form of ownership was superior to the traditional publicly-owned corporation. The intense investor oversight associated with LBOs, their equity-linked management compensation packages, and a highly-leveraged capital structure each combined to provide high-powered incentives to force firms to divest underperforming assets and to streamline operations. Moreover, these theoretical propositions were tested in a substantial body of empirical work that demonstrated that LBOs did in fact create value for their investors by creating leaner, more efficiently-run organizations (e.g., Kaplan 1989; Lehn & Poulsen 1989; Smith 1990).

There are at least two important reasons, however, to question whether the findings of the prior buyout boom apply to the most recent wave of take-private LBOs. First, both the LBO industry and the behavior of most publicly-traded companies have evolved considerably since the 1980s takeover boom. As shown below, a consequence of this evolution has been the development in the late 1990s of novel LBO transaction strategies that have focused more on top-line revenue growth rather than bottom-line operating efficiencies. To the extent modern LBOs adopt these strategies, the value of LBOs might arise not necessarily from greater operating efficiencies but from greater revenue growth. This development, in turn, would make prior methodologies that examined changes in operating cash flow ill-suited for measuring the value proposition offered by more modern, growth-oriented LBOs. Indeed, this fact alone might help explain why Guo, Hotchkiss and Song (2008) found in their recent study of 192 LBOs between 1990 and 2006 that LBOs led to only minor changes in firms’ operating cash flows compared with earlier studies of the 1980s buyout wave, notwithstanding the fact that the LBOs, on average, continued to produce large positive returns to their investors.

^a University of Georgia School of Law.

^b Terry College of Business, University of Georgia.

Equally important, prevailing studies of LBOs—both past and current—have long struggled with measuring the returns to LBO sponsors from individual portfolio company investments. Even where a portfolio company publicly discloses its financial results, the company may not necessarily disclose clearly the timing and amount of an LBO sponsor's disbursements to and from the company, making difficult the calculation of the sponsor's internal rate of return (IRR) on the investment. As a result, most studies of LBOs have had to rely on a transaction's total return to invested capital (debt and equity) when assessing how buyouts create value for their investors, typically by reference to the total return on capital measured as of a particular exit event (e.g., the time of a portfolio company's IPO, its acquisition or its bankruptcy). These returns are then discounted by the returns on industry sectors that are presumed to have the same exposure to systematic risk (i.e., have the same asset beta) as the individual portfolio company.

Yet such an approach—while providing insight into whether a particular transaction exceeded an industry's mean weighted-average cost of capital through the date of exit—relies on a potentially misleading variable for purposes of measuring LBO value creation. In particular, focusing on aggregate returns to total invested capital as of an exit event overlooks the critical challenge facing LBO sponsors that must liquidate their investments after a formal exit event has occurred. Specifically, unless an LBO sponsor exits its investment in a portfolio company by selling the company in a cash acquisition, liquidating an LBO investment may be delayed by both contract provisions and federal securities laws that limit a sponsor's ability to monetize its post-exit securities holdings. In either case, the delay can significantly reduce a sponsor's final, realized cash return on equity—the most accurate metric by which to measure whether and how an LBO creates value for its investors. For similar reasons, focusing on return to total invested capital as of an exit event obscures how LBO sponsors might operate portfolio companies to maximize these realized returns to equity, for instance by adopting a dividend policy that can dramatically increase its realized IRR without necessarily changing a portfolio company's operating performance. As a consequence, focusing on returns to total invested capital as of an exit event may lead to an inaccurate assessment of which operating strategies and transaction structures produce the greatest real value for an LBO's investors.

In short, understanding whether and how take-private LBOs create value for their investors requires grappling directly with the relationship between LBO transaction structure and the realized returns to LBO investors. Certainly, the conventional approach to LBOs with its emphasis on enhancing operating efficiencies is one potential way for LBO sponsors to create value in LBOs. But an LBO can just as easily be focused on achieving returns by means of transaction structures that have little to do with improving a company's operating efficiency. As noted previously, some LBOs may be structured primarily to grow a portfolio company's revenues while others might be designed primarily to sell quickly (or "flip") what is perceived to be an under-priced asset. Moreover, in a world with multiple LBO transaction strategies, the returns from each transaction strategy may arise from different sources (operating efficiencies in the case of the traditional LBO, revenue growth in the case a growth LBO, temporary market mispricings in the case of a quick-flip LBO), making examination of transaction strategy a critical first step in understanding how and whether LBOs continue to produce value.

Accordingly, this paper examines how LBOs create value for their investors by investigating the role of transaction strategy on the realized internal rates of return for a sample of successful public-to-private LBOs occurring between 1998 and 2006. Focusing on successful LBOs—defined as those achieving an investment exit by means of either an IPO or acquisition of the portfolio company—provides a direct means to isolate in the first instance those transaction strategies that have been successfully used by LBO sponsors to create value in take-private acquisitions. At the same time, an LBO that exits by means of an IPO or acquisition will also provide public information concerning its equity sponsor’s history of contributions to and disbursements from the company, thereby permitting a unique opportunity to analyze the IRRs for individual LBOs on both a realized and unrealized basis. Currently, our sample consists of thirty-five transactions that provide sufficient public information regarding LBO sponsors’ contributions to and disbursements from each transaction to permit calculation of sponsor IRRs. Specifically, for each transaction in the sample, we estimate the nominal unrealized and nominal realized IRR for the LBO sponsor. (In future versions, we will also estimate these returns on an industry-adjusted basis). We find, on average, positive IRRs for the sample with mean (median) unrealized IRRs at 426% (38%) and unadjusted realized IRRs estimated at 46.5% (36%). There is, however, substantial cross sectional variation in these aggregate returns.

To explain these variations, we turn to three hypotheses about the role of transaction strategy in the most recent wave of LBOs. Each strategy has wide currency in both the industry press and academic commentary as representing a “type” or “model” of LBO, with specific implications for post-LBO operating strategy and the source of value-creation in LBOs. While any given LBO might demonstrate traits of all three models, the intuition is that each model represents the central tendency for an LBO. Accordingly, categorizing LBOs by transaction-type provides a way to test the extent to which real world LBOs adhered to these models as well as to test the extent these transaction types actually influence LBO returns.

Overall, our findings demonstrate that the modern LBO has evolved considerably from the 1980s. As public companies have adopted many of the innovative techniques of the first wave of LBOs (e.g., greater equity compensation), LBO firms have responded with innovations in transaction strategy that create value for their investors in ways that are often unrelated to efficiency enhancements in their portfolio companies. In particular, LBOs today commonly use three distinct transaction strategies which help explain how LBOs create value for their investors. In addition to the traditional, “classic” form of the LBO, the most recent wave of LBOs witnessed the emergence of an “entrepreneurial” strategy that emphasizes growing revenues through add-on acquisitions rather than improvements to a company’s operating efficiency. A third “opportunistic” form of LBO also appears to have emerged in which an LBO sponsor seeks to accelerate cash payouts from a portfolio company in hopes of maximizing equity IRRs.

Ultimately, by demonstrating the critical role of transaction strategy and securities laws for LBO returns, the paper provides a more accurate assessment of how LBOs continue to create value for their investors while illustrating more generally the benefits of incorporating into finance research the legal and transactional context in which market participants interact.

References

- Guo, S.E. Hotchkiss, and W. Song, 2008, "Do Buyouts (Still) Create Value?" Working paper, Boston College.
- Jensen, Michael, 1989, "Eclipse of the Public Corporation," *Harvard Business Review* 67, 61-74.
- Kaplan, S., 1989, "The Effects of Management Buyouts on Operating Performance and Value," *Journal of Financial Economics*, 24, 217-254.
- Lehn, K. and A. Poulsen, 1989, "Free Cash Flow and Stockholder Gains in Going Private Transactions," *Journal of Finance* 44, 771-787.
- Smith, A., 1990, "Capital ownership structure and performance: the case of management buyouts," *Journal of Financial Economics*, 13, 143-165.