Nicolaus Loos

Value Creation in Leveraged Buyouts

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Analysis of Factors Driving Private Equity Investment Performance

With forewords by Prof. Dr. Martin Hilb/Prof. Dr. Beat Bernet and Prof. Oliver Gottschalg, PhD/Prof. Maurizio Zollo, PhD

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To my Mother Beatrice –
For her Love, unrelenting Dedication
And Support towards my Education

Foreword I

The academic and public discussion about Private Equity and Buyout firms and their current acquisition frenzy has once again reached a climax in recent months. The reasons are twofold:

Firstly, the flexibility and sophistication of Private Equity investors, as well as the capital markets serving them, has increased dramatically over the recent years. The current availability of funds to be invested by Private Equity managers is enormous, estimated to be over $150 billion. Equity and debt is raised from institutional investors, pension funds and other asset managers who are keen to put their money to work in high-yielding investment areas and who continue to be highly receptive to Private Equity following a strong recent return track record of this asset class. Relatively cheap lending levels based on stable global economic outlook, as well as a much lower than historical level of default rates among buyouts has led banks to increase their risk appetite noticeably. Consequently, lending banks are offering significant additional financing sources to Private Equity investor clients. The year 2005 has been a record year in the industry in terms of overall deal volume including 845 leveraged buyout transactions totalling $198 billion in transaction value globally. This is in addition to a record $448 billion in leveraged loans being raised in the global capital markets. Buyout deal sizes have reached new heights with 45% of U.S. LBO transaction volume being $2 billion or greater and buyout sizes in 2005 quickly approaching new records, e.g. with the $15.0 billion buyout of Hertz and the $11.3 billion buyout of Sungard in the U.S., as well as the $15.3 billion buyout of Danish telecommunication company TDC – the second largest buyout ever – in Europe. The list of large and established listed companies that could hypothetically be targeted by Private Equity firms is constantly growing.

Secondly, based on the above mentioned trends, Private Equity has once again moved into the public debate arena. The influence and power that Private Equity firms have gained in today's capital markets has led some observers to be vocally concerned: Private Equity firms – and their like-minded, but often more short-term oriented colleagues in the Hedge Fund world – have gained a highly active role in exercising corporate governance change at listed corporations today. They have equally become heavily involved in turning around the fates of countless mis- or under-managed, sometimes already insolvent companies, thereby implicitly often becoming responsible for the destiny of thousands of employees and their families. Especially in Europe, and in particular in Germany, the recent buyout activity has prompted mostly socialist party leaders to condemn Private Equity as capitalistic "locusts", who simply buy out solid, healthy (German) companies, exploit them, and then move on to their next "prey". Notwithstanding the unqualified nature of such remarks, it should rather be highlighted at this stage that the phenomenon of such public outcry is nothing new. In fact, the current debate simply finds a "second spring" in Europe, while the original discussion had already started during the 1980s in the United States, where hostile takeover activity and leveraged buyouts were pretty much on the "everyday menu". Serious academic interest in the buyout phenomenon began during the second half of the 1980s, and several landmark studies and early work by Michael C. Jensen and Steven N. Kaplan, followed by others, soon proved that this new breed of "active investors" (Jensen) actually played a vital role in addressing management inefficiencies throughout Corporate America. Therefore, these investors should rather be seen as economically important and hence a "necessary evil". With these ideas in mind, how do we go about evaluating the apparently repeating history with respect to the current surge in Private Equity activity? What education and recommendations must we provide – not only to students, academics and practitioners – but also to the likes of populist politicians, stunned investors and concerned outside observers? How do we exercise proper judgement in order to protect all stakeholders' interest?

An attempt to answer these and other related questions is provided in this dissertation. The author has embarked on a "fact-finding mission", unfolding the complexity of the Private Equity asset class and in particular the leveraged buyout transaction to the reader. The aim of this study was first of all to alleviate some of the common beliefs about buyout investors, and secondly to substantiate that argumentation by making explicit where the sources of the evident value creation – which Private Equity firms seem to be pursuing so aggressively – come from. The author has singled out three key areas of value creation in concert with industry experts and has utilized quantitative research on an enviable dataset of buyout transactions to examine each respective area. The vast and intriguing results of this study not only offer novel insights into the Buyout phenomenon, but also contribute meaningfully to the above outlined academic and public discussion by providing an intellectual basis. The contribution of this work can therefore be seen as providing a crucial step forward in allowing us to make a more educated judgement (i) in the context of examining the extent of creation or destruction of value by Private Equity firms, as well as (ii) about which methodologies employed by these companies may be considered ethical or unethical. The author's work without doubt suggests that the economic justification for the existence of Private Equity firms is granted: for example, under these firms' ownership buyout target companies clearly outperformed their industry peers both operationally and financially. This leads to the generation of abnormal economic rents for shareholders on the one side, but at the same time also creates considerably more scope for future investment at the company, leading to new job creation, and hence contributes to overall higher economic welfare. The author makes several important contributions to theory by testing both agency theoretical and strategic management theoretical constructs in the leveraged buyout context.

The presented dissertation can overall be seen as demonstrating a high degree of innovation and applied academic standards. In spite of its explorative character and holistic research approach, the work remains directly relevant to practitioners' education and application through formidable graphical and qualitative description of findings. The range of highly interesting questions and answers on all aspects of the value creation process in leveraged buyouts, often reinforced by strong levels of statistical significance, should be seen as a valuable contribution to the ongoing discussion and research in the field and could serve as basis for future studies.

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Foreword II

There are few areas in which the imbalance between the economic and social importance of a phenomenon on the one hand, and the available amount of rigorous and data-driven findings from academic research on this phenomenon on the other hand, is as striking as it in the Private Equity domain – in particular in the buyout area. Every year, buyouts affect hundreds of companies, tens of thousands of employees and other stakeholders, as well as a large group of investors. Successful buyouts contribute to the revitalization of mature and sometimes underperforming companies, to the enhanced competitiveness of entire industry sectors and to the wealth of countless of individual investors – which are not only high-net-worth limited partners, but also stakeholders in pension funds. Unsuccessful buyouts, on the contrary, lead to bankruptcies, layoffs and massive destruction of shareholder value. Understanding the value creation logic and strategic success factors of leveraged or management buyouts is therefore of crucial importance, and only rigorous and data-driven research can help illuminate the "buyout black-box". While few people would disagree with this assessment, progress in the area of buyout research has been slow compared to other areas of finance or strategic management. This is certainly not due to a lack of interest in the buyout phenomenon on behalf of the academic community, but a result of the proverbial secrecy of an industry that – not without reason – calls itself *private* equity, and to which buyouts belong. For decades, reliable information about the characteristics and the performance of a large and unbiased worldwide sample of individual buyout transactions has been unavailable for academic research. Hence researchers have been highly limited in the degree to which they could address the fundamental buyout success factors in their work.

This dissertation constitutes without a doubt a true pioneer's effort in terms of gathering and codifying of crucial (often qualitative) information on buyouts into a format suitable for statistical analyses. Through this effort the author composed a data source of unprecedented breadth and depth on thousands of buyouts worldwide, including many details about the acquirer and the portfolio company. The author leverages this data to look at an exceptionally broad range of questions related to buyout success factors that prior research was often unable to address in the same breadth and depth due to data limitations. This monumental effort led to a quantum leap in terms of research insights relative to the *status quo ante*. At the same time, one dissertation can also only be one – albeit huge and important – first step towards the goal of comprehensively understanding what determines buyout success or failure. Here lies an additional important contribution of this dissertation, as it serves as a powerful roadmap for future research. As others will follow into the author's footsteps and continue to improve the breadth, depth and quality of the available data on buyout transactions, his work will be the basis for subsequent analyses that will be even stronger in terms of statistical power and hence in its ability to consider a broader range of variables simultaneously.

In summary, the presented study is what we consider to be a true landmark study in empirical buyout research. It shows what is possible to achieve through aspiration, inspiration and persistence even in an industry that is thorny territory for empirical research. At the same time, it points to a variety of fruitful avenues for future research in the buyout area that we would love to see explored in full depth by subsequent work. This will not only lead to additional insights of academic value, but also help the main actors in the buyout industry to manage buyouts even better than they currently do.

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