RSM Insight

***Management** Knowledge*

13

1st Quarter 2013

ROTTERDAM SCHOOL OF MANAGEMENT, ERASMUS UNIVERSITY

A broader scope of influence
by Lesa Sawahata

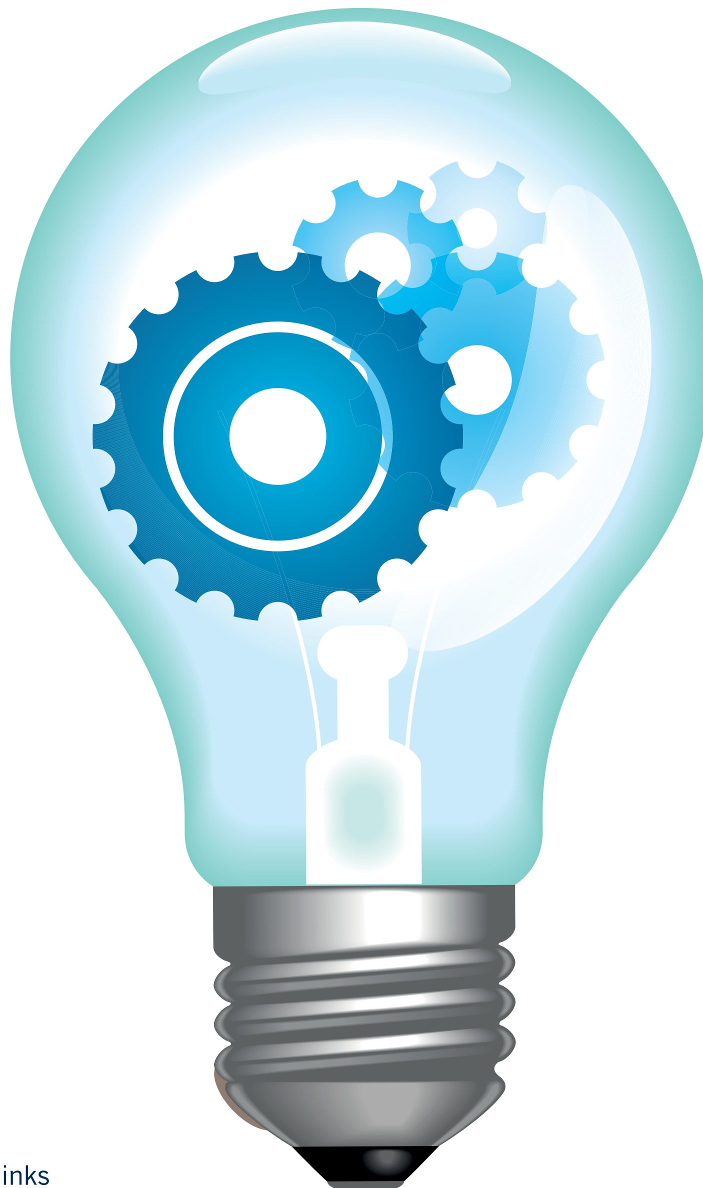
The competitive advantage of private label branding in FMCG
by Maciej Szymanowski

The effect of blockholders in corporate governance
by Hans van Oosterhout, Pursey Heugens and Marc van Essen

Making business sense of cross-industry innovation
by Ferdinand Jaspers and Jan van den Ende

A broader perspective: harmonising leadership activities
by Marius van Dijke

Private equity and public-to-private transactions
by Peter Roosenboom



The business school that thinks
and lives in the future

RSM
ERASMUS UNIVERSITY

Private equity and public-to-private transactions

by Peter Roosenboom

What considerations lie behind the decision to mount a management buy-out of a publicly listed firm, and should third party investors be involved? Indeed, does the involvement of private equity investors actually aid company performance after a deal is done?

Private equity in its purest sense is more a facilitator of management buy-outs that result in a listed company being taken off a public stock exchange rather than an adder of value to the target company's performance.

This is one of the key findings of research into the subject that I undertook alongside colleagues from Warwick Business School and the Econometric Institute, Erasmus University Rotterdam. A key corollary is that managers would much prefer to carry out such transactions without third-party involvement.

The root of the motivation that drives management behaviour is to be found in the underlying reasons behind the decision to mount a management buy-out in the first place.

There are several principal reasons that can be readily identified in any given set of transactions (the transactions examined in this case included a series of deals enabled by private equity involvement in the UK between 1997 and 2003, featuring a wide range of companies in an equally wide range of industry sectors; they include United Biscuits, Pizza Express, Dewhurst, Fortnum & Mason, Anglian Group, Fitness First, Brake Brothers, and Osborne & Little, this last one being the family company of the current UK Chancellor of the Exchequer, George Osborne).

One, the senior management might want to cancel a company's public listing because they have lost the appetite for complying with the public reporting and governance requirements that are part and parcel of the listing. All other considerations aside, the reporting requirements increase the risk of losing control of proprietary information to competitors.

Two, senior management might feel that a company is undervalued, which increases the risk of it being the subject of a hostile takeover, and the loss of senior management jobs.

Three, the pressure of constant public and media scrutiny. Four, the absence of interest from industry analysts and the investing public, resulting in low liquidity. Taken together, these factors can combine to make it difficult, perhaps even impossible, for a company to take advantage of its public status, most notably issuing shares to finance growth, whether of the organic kind or by acquisition.

Such considerations will almost always raise the possibility of private equity involvement in determining a company's short-, medium- and long-term future. Over the past 25 years, the sight of private equity firms joining forces with incumbent management to stage a buy-out has become a familiar element on the commercial landscape.

In certain cases, management might be able to mobilise enough bank finance to complete a purchase on their own. This might arise in situations where a company is seen to be undervalued, and has ample cash reserves on its balance sheet that could be deployed to finance a buy-out; the ability to keep total control of a company, and so derive maximum benefit from any post-buy-out improvement, would certainly increase the attractions of taking this route to ownership.

More commonly, however, the help of one or more private equity investors will be needed to enable a deal to proceed, not least because of their ability to arrange the necessary additional external financing. There exists a very simple equation: the larger ▸

Private equity and public-to-private transactions (continued)

by Peter Roosenboom

a company is, the less likely it is that its managers will possess the sums of money required to take it private.

In the research, we focused on deals in which managers remained in their positions after going private to ensure that they are active decision makers in the going private process. We use two complementary approaches to investigate private equity participation in these going private transactions.

The first part of our analysis explores which firm characteristics are associated with managers seeking private equity backing as an alternative to conducting the deal on their own without outside equity capital and assistance.

Thus, we compare pure management buyouts (MBOs) and private equity-backed (PE-backed) deals to a control group of firms that remained publicly listed. Such analysis provides important insights into managers' choice of the particular route to take their firm private but assumes passive private equity investors.

The second part of our analysis addresses this assumption and compares the post-deal performance of MBOs versus PE-backed deals. This enables us to determine whether private equity investors add extra value in performance improvements post-deal or are simply good in the cherry picking of targets that are expected to perform well.

My own thinking today reflects the observations made as part of the research process. Companies that were the subject of MBOs without PE involvement, tended not to outperform their peer group before delisting, but did so afterwards. This is what I would expect of a company whose senior managers will now benefit directly from being owners of their company, rather than hired hands.

The PE-backed companies placed under the microscope, by contrast, were already outperforming their peer group. This would suggest to me that the private equity investors involved inclined towards cherry-picking. In short, pure private equity investors bringing nothing more to the table than finance were only seriously interested in those companies that were already doing well.

This is an important consideration that senior management teams considering mounting a buy-out should factor into their thinking when deciding just how to structure their planned transaction. Should they involve private equity backers, knowing that they might well prove to be mere deal facilitators rather than post-deal value-adders? Or might they somehow manage on their own, and keep all the gains for themselves? ■

Peter Roosenboom is Professor of Entrepreneurial Finance and Private Equity, Department of Finance, Rotterdam School of Management, Erasmus University.
EMAIL proosenboom@rsm.nl

This article draws its inspiration from the paper *When Do Managers Seek Private Equity Backing in Public-to-Private Transactions?* by Jana P Fidrmuc, Alessandro Palandri, Peter Roosenboom (Erasmus University) and Dick van Dijk. Published in *Review of Finance Advance Access*, June 28 2012. (http://rof.oxfordjournals.org/content/early/2012/06/28/rof.rfs021)

RSM Expertise

The internationally focused Department of Finance at RSM conducts research that has both business and academic impact in two main areas: corporate finance, and investment. The department is a meeting place for ambitious academics and dedicated educators in the field of corporate finance and investments and is part of the Erasmus Finance Group. More information on its activities can be found at:

WEB www.rsm.nl/fin