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Contents

A Framework for Examining the Heterogeneous Opportunities of Value Creation in Private Equity Buyouts

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ABSTRACT

PE firms and buyouts have emerged as a field of significant interest for academic research and attracted the increasing attention of policy makers, public opinion and popular press. In particular, there is a strong debate on how private equity firms create value in buyout investments. Notwithstanding this widespread interest in value creation in private equity, there is a lack of research offering an overall view of the various mechanisms by which value can be created in buyout investments. We contribute to shed new light on this issue by reviewing the body of research on value creation and by proposing an overall framework for mapping the heterogeneous opportunities to create value.

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1

Introduction: Towards an Extended Taxonomy

The modern private equity and buyout market developed from the mid-1970s with the transfer of ownership of listed corporations, divisions of large groups and family firms to newly created independent privately-owned entities funded by substantial debt and small amounts of equity provided by specialist investors in which management typically obtained significant equity stakes (Coyne and Wright, 1982; Kaufman and Englander, 1993; Wright *et al.*, 2000).

This transfer of ownership facilitated by high levels of leverage gave rise to the term leveraged buyouts (LBO) to describe the market. The levered investment takes the name of management buyout (MBO) when the transaction involves the existing managers and management buy-in (MBI) when it involves a new management team. Following controversies in the 1980s about the adverse effects of some highly leveraged deals making the LBO term toxic, as well as some evolution in the types of deals being conducted, the market was relabeled the private equity and buyout market (Gilligan and Wright, 2014).

The fundamental drivers of value generation[1] emerged with the first wave of buyouts in the mid-1970s to the 1980s. In broad terms, there

[1] Value generation is defined in economic terms implicitly from any positive NPV after subtracting the entry price from the exit price.

are three principle mechanisms that add value: reductions of the opportunity cost of capital, increasing operating cash flows, and accelerating financing payments. However, these mechanisms provide little insight into how these increases in value can be achieved. Accordingly, studies have explored more fine-grained drivers of value creation.

The various techniques for acquiring companies with substantial amounts of debt financing and benefitting from resulting tax shield became known as financial engineering. A particular form of arbitrage crucial in the early 1980s was to take advantage of the conglomerate discount. This term denoted the discount by which a public multi–business corporation was valued at a lower multiple than the combined value of its assets. By divesting assets and business units, investors could remove the discount and benefit from the value appreciation.

Another early driver for improving buyout targets became known as corporate governance and involved the active involvement of investors, initially known as LBO associations and subsequently private equity firms. Typically, private equity firms were general partners (GPs) in the closed end funds they raised from institutional investors (limited partners, LPs). This stream of research highlighted that corporate governance can be used to reduce the costs associated with the agency problem (Jensen and Meckling, 1976; Lowenstein, 1985).

The value improvement potential was fueled by the intent to mitigate the agency conflict through incentive realignment and by disposing accumulated cash flows (Jensen, 1989b; Kaplan, 1989). For instance, since buyouts are typically financed with substantial amounts of debt, they can function as a dividend substitute to dispose of the excess free cash flow (Jensen, 1989a). A central and related driver of the buyouts was the notion that the alleged lethargy that plagued the public corporations in the 1970s, was due to a fundamental disconnect between ownership and management. The agency conflict appeared to be particularly prevalent in mature industries with low to moderate growth prospects. Since finance providers rarely have direct access to internal information of the firm, they thereby incur additional risk. For instance, when the incumbent management invest resources on projects with significantly higher risk than deemed acceptable by the investor. More broadly the moral hazard scenario can be expressed as a bet, where the downside risk has been transferred to the financial provider, while the upside remains with the actor making the bet.

During an MBI the management team raise the funds to carry-out an acquisition. Typically, a combination of buyout fund capital and bank debt is used to acquire the firm. After the acquisition, the shares of the firm are owned by the new management and the buyout fund. The continuous cash-flows generated by the firm are used to serve debt amortizations. The new management and fund investors are remunerated during an exit.

By the late 1980s the evidence was mounting that buyouts are associated with significant operating and productivity improvements (e.g., Baker and Wruck, 1989; Bull, 1989; Kaplan, 1989) and the techniques for achieving improvements became known as operational engineering. From the 1990s strategic redirection emerged as a key driver of the value creation through the alternatives focusing on the core and buy and build strategies, as well as organic entrepreneurial and innovative activities (Amess *et al.*, 2015; Lerner *et al.*, 2011; Meuleman *et al.*, 2009; Ughetto, 2010; Wright *et al.*, 1992; Zahra, 1995).

There are several reviews of buyout performance (e.g. Cumming *et al.*, 2007; Wright *et al.*, 2009), leverage buyouts (Renneboog and Vansteenkiste, 2017), the early development of the buyout literature (Berg and Gottschalg, 2005) and of employee-related aspects (Wood and Wright, 2009). However, we lack a structured framework to synthesize the value creation drivers, several of which have been identified only recently. Moreover, new value creation drivers have emerged recently in fields other than finance but have not been included in existing frameworks.

In an effort to define the state of the art of this literature, we specifically review the body of papers on value creation in buyout investments and propose an overall framework for mapping the heterogeneous opportunities to create value. Papers included in this review were searched by using the following keywords: Buyouts, Private Equity, Value Creation, Portfolio Firms, LBO, MBO, MBI. As papers on private equity have appeared in a wide range of journals across a number of fields including finance, strategy, entrepreneurship, economics, etc. we adopted a wide search rather than restricting it to a small number of journals in one or other field. As for the time frame, we do not impose any constraint in our search. Afterwards, each of the papers was subject to an in-depth reading and discussion process to determine whether or not it dealt with value creation in buyout investments.

Based on our wide-ranging literature review, we identify seven distinct value creation drivers: the financial, operational, strategic, governance, cultural, commercial and institutional drivers. The identification of these drivers allows us to capture and systematize the findings of all fields of research, even those that have not been included in existing frameworks. The findings of each paper are first assigned to one of the seven drivers and then to one of the sub-drivers, which are narrower classifications containing the findings of papers related one another. Overall, we identify 32 sub-drivers divided across the different drivers. Figure 1.1 provides an overview of all drivers and sub-drivers. Note that there are potentially overlaps between subdrivers, which we also discuss below.

1. FINANCIAL DRIVERS	**4. GOVERNANCE DRIVERS**	**6. COMMERCIAL DRIVERS**
1: Financial Expertise and Contact Networks	1: The GP Effect: Experience and Expertise Matters	1: Proprietary Deal Flow
2: Debt Market Cycles: Mispricing and Overheating	2: Reducing Agency Costs: Incentivization and Interest Realignment	2: Deal Making Expertise
3: Alleviating Capital Market Constraints	3: Restructuring the Board of Directors	3: Target Firm Identification and Investment Criteria
4: The Effects of High-Leverage: Inflating Gains, Inducing Efforts	4: Reinforcing the Management Team	4: Uncovering the Business Potential
5: Capital Structure Optimization in Buyouts		5: Detecting Nascent Market Trends: Multiple Expansion
		6: Timing the Business Cycles
		7: The Entry Transaction: Firm Valuation Criteria
		8: Divesting the Firm: The Mode of Exit
2. OPERATIONAL DRIVERS	**5. CULTURAL DRIVERS**	**7. INSTITUTIONAL DRIVERS**
1: Functional Experience and Operational Expertise	1: The Parenting Advantage: Monitoring and Mentoring	1: Mitigated Legislative and Regulatory Constraints
2: Cost Structure Improvements	2: The Value of Corporate Culture: A Revived Entrepreneurial Spirit	2: The Corporate Tax Shield: Debt and Taxes
3: Capital Management and Asset Utilization	3: Performance Management: Stretch Budgets, Ambitious Goals	3: Carried Interest and Capital Income
	4: Revising the Firm KPIs: Novel Yardsticks	
3. STRATEGIC DRIVERS	5: High-Tempo and Inchoate Change	
1: Focusing on the Core: Complexity Reduction	6: The Holding Period Time Horizon	
2: Focusing on Consolidation: Buy and Build Strategies		
3: Focusing on Growth: Market Expansion		

Figure 1.1: Value creation drivers and sub-drivers.

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