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Corporate Restructuring*

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Abstract

We survey the empirical literature on corporate financial restructuring, including breakup transactions (divestitures, spinoffs, equity carveouts, tracking stocks), leveraged recapitalizations, and leveraged buyouts (LBOs). For each transaction type, we survey techniques, deal financing, transaction volume, valuation effects and potential sources of restructuring gains. Many breakup transactions appear to be a response to excessive conglomeration and attempt to reverse a potentially costly diversification discount. The empirical evidence shows that the typical restructuring creates substantial value for shareholders. The value-drivers include elimination of costly cross-subsidizations characterizing internal capital markets, reduction in financing costs for subsidiaries through asset securitization and increased divisional transparency, improved (and more focused) investment programs, reduction in agency costs of free cash flow, implementation of executive compensation schemes with greater pay-performance sensitivity, and increased

* This monograph updates Eckbo and Thorburn (2008) with new data and research developments. It was in part written while Thorburn was a Visiting Professorial Fellow at the Australian Business School at University of New South Wales.

monitoring by lenders and LBO sponsors. Buyouts after the 1990s on average create value similar to LBOs of the 1980s. Recent developments include consortiums of private equity funds (club deals), exits through secondary buyouts (sale to another LBO fund), and evidence of persistence in fund returns. LBO deal financing has evolved toward lower leverage ratios. In Europe, recent deals are financed with less leveraged loans and mezzanine debt and more high-yield debt than before. Future research challenges include integrating analyses across transaction types and financing mixes, and producing unbiased estimates of the expected return from buyout investments in the presence of limited data on portfolio companies that do not return to public status.

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1

Introduction

Shocks to the corporate economic environment may give rise to severe organizational inefficiencies. For example, a vertically integrated firm may find that long-term contracts and/or spot market purchases of a key input have become more efficient. Or increased general capital market liquidity may have rendered internal capital markets a relatively costly divisional funding mechanism for conglomerates. High leverage may be optimal as financial innovations and expertise make it less expensive to manage financial distress. Financial innovations and general market liquidity may also render it optimal to securitize an entire division. The result is increased divisional managerial focus. In this monograph, we collectively refer to the transactions that implement these and other changes in asset composition, financial contracting, and ownership structure as "corporate restructuring".

We focus the survey on two broad groups of corporate restructuring procedures: corporate breakups and highly leveraged transactions. Corporate breakups include techniques to sell off and/or securitize part of the firm. They include divestitures, spinoffs, equity carveouts, and, for a brief period, tracking stock. Highly leveraged transactions involve a significant increase of debt in the firm's capital structure, either through a debt-financed special dividend in a leveraged recapitalization, or in a leveraged buyout (LBO), in which the entire firm is acquired by a financial buyer (a buyout fund).

In order to limit the scope of the survey, we do not review recapitalizations that do not involve extensive use of leverage. Examples include state privatizations (Megginson and Netter, 2001), conversions from mutual to stock companies (Masulis, 1987), and stock repurchases (Kalay and Lemmon, 2008). Moreover, for a review of the broader literature on corporate takeovers and takeover bidding involving strategic buyers, see Betton et al. (2008). Also, we address distressed restructuring only tangentially (Hotchkiss et al., 2008; Senbet and Wang, 2012).

As surveyed below, corporate restructuring may be initiated by top-level management, by divisional managers, or by outside sponsors like buyout funds. Occasionally, the restructuring is defensive, arising in response to a control threat from the market for corporate control. Regardless of who initiates the transaction, the parties are likely seeking to improve operating efficiency, increase cash flow, and ultimately, enhance firm profitability. In breakup transactions, the evidence suggests that assets are transferred to higher-value users, while highly leveraged transactions involve optimizing capital structure, improving managerial incentives and achieving tax efficiency.

The monograph is organized as follows. Chapter 2 introduces the so-called diversification discount and the potential costs of diversification, which seem to motivate many breakup transactions. Chapters 3 through Chapter 6 then detail the frequency, structure, and economic effect of various types of breakup transactions, beginning with divestitures (Chapter 3), spinoffs (Chapter 4), equity carveouts (Chapter 5), and ending with tracking stock (Chapter 6). Next, we review highly leveraged transactions, including leveraged recapitalizations (Chapter 7), and we provide an extensive discussion of the empirical evidence on LBOs (Chapter 8). Chapter 9 concludes the monograph.

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