Research in International Business and Finance 36 (2016) 641–655

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

The likelihood of management involvement, offer premiums, and target shareholder wealth effects: Evidence from the 2002–2007 LBO wave

Kien Cao [a], Jeffrey Coy [b], Thuy Nguyen [a,*]

[a] *Faculty of Business Administration, Foreign Trade University, 91 Chua Lang Street, Hanoi, Viet Nam*
[b] *Sam and Irene Black School of Business, Pennsylvania State University-Erie, 4701 College Drive, Erie, PA 16563, USA*

ARTICLE INFO

Article history:
Available online 19 January 2015

JEL classification:
G34

Keywords:
Leveraged buyout
Management buyout
Agency cost hypothesis
Information asymmetry hypothesis
Offer premiums
Market volatility

ABSTRACT

This study analyzes the likelihood of management's involvement, the determinants of the offer premium and the market's reaction to the target in order to evaluate the pervasiveness of the agency cost motive and the information asymmetry motive in LBO transactions in the most recent LBO wave. In addition, we consider the role that market volatility plays in the key elements of LBOs. There is strong evidence to suggest that market volatility plays an important role in determining all three elements under investigation due to its effect on the market value of the firm. In addition, management's involvement has a strong positive effect on offer premiums indicating that positive information asymmetry remains to be a motive for management's involvement in LBOs. The agency cost hypothesis is also supported in all three analyses and there is evidence that increased financial distress costs are a concern to private equity groups.
© 2015 Elsevier B.V. All rights reserved.

1. Introduction

Prior to the 1980s, leveraged buyouts (LBOs) on small companies were commonplace in the United States. A leveraged buyout (LBO) is a form of going-private transaction, financed primarily with debt,

* Corresponding author. Tel.: +84 936576494.
E-mail address: thuy.nt@ftu.edu.vn (T. Nguyen).

http://dx.doi.org/10.1016/j.ribaf.2015.01.002
0275-5319/© 2015 Elsevier B.V. All rights reserved.

involving the tender offer for the common stock of an existing company. However, the 1980s saw the first wave of leveraged buyouts (LBOs) of large public companies. The catalysts of this wave of large public firm LBOs are both regulatory and economic in nature. Regulatory factors include the 1982 Supreme Court decision that limited state antitakeover laws; the deregulation of certain industries; and the overall liberal noninterference policies put forth by the Reagan administration. These regulatory changes inspired various mergers and restructurings that may not have been allowed in previous years.

On the economic side, the popularity of high-yield debt instruments, largely credited to Michael Milkin of Drexel Burnham, opened up large amounts of needed capital to private LBO firms allowing them to engage in much larger transactions. In 1989, right before the end of the 80s LBO wave, the largest LBO transaction in history occurred as Kohlberg Kravis Roberts & Co. completed a $31.1 billion takeover of RJR Nabisco. Following this colossal takeover, the LBO industry almost completely faded away as Drexel Burnham Lambert, one of the Wall Street's largest investment banking firms, collapsed, along with the high-yield debt market. This period magnified the overabundances of the buyout market, culminating with the bankruptcy of many of the large LBOs of the 80s during the first couple of years of the 90s. The LBO market was marked by a period of stagnation in the 1990s, through the internet bubble and subsequent burst, and into the early 2000s.

By the end of 2002, certain regulatory and economic conditions, once again, set the stage for a boom in private equity markets. Consistent decreases in interest rates increased the ability of private equity firms, through decreased borrowing costs, to raise the funds necessary to finance large acquisitions. The lowering of lending standards that was at the heart of the mortgage lending boom also allowed for this increased ability of private equity firms to raise capital. In addition, the passing of the Sarbanes–Oxley Act in 2002 created new regulations for publicly traded companies. These new regulations made private equity ownership a more attractive option for some public firms as they evaluated the extra costs of compliance as well as the overall headaches of dealing with the bureaucracy associated with reform. The magnitude of these conditions on the private equity market was much larger than that which occurred during the LBO boom of the 80s. Rizzi (2009) quotes a private equity analyst who reports that the funds raised during the 2004–2007 period alone were more than that raised by the entire industry combined since its inception in the early 80s.

There has been extensive empirical work on the motives of a firm to go private as well as on the wealth creation of the LBO wave of the 80s for both target firms as well as bidders. These motives are predominately born out of the work of Jensen and Meckling (1976) and Fama and Jensen (1983) who contend that the maximization of firm value can be achieved by either being publicly held or by being privately held, depending on the individual firm. Myers and Majluf (1984), Kim and Lyn (1991), and Kaestner and Liu (1996) find evidence supporting the information asymmetry motive of taking the firm private while Lehn and Poulsen (1989) posit that taking the firm private is a rationale to repel a takeover threat. Jensen and Meckling (1976), Myers (1977), Kim and Sorensen (1986), and Jensen (1989) all find evidence in advance of the general agency cost of debt motive while Jensen (1986) and Lehn and Poulsen (1989) point to the specific free cash flow hypothesis as an agency cost theory of undertaking an LBO.

With these motives for going private in place, the empirical work on the value creation of the LBO wave of the 80s indicates that they do indeed create value in various ways, such as the operating performance gains attributable to reduced agency costs. This reduction in agency costs is due to the disciplining effects of leveraging and better governance (monitoring by the financial sponsor). Andrade and Kaplan (1998) find that even financially distressed firms that engage in highly levered transactions (HLTs) earn a positive market-adjusted return providing evidence that *all* HLTs are wealth creating. In their evaluation of the difference in abnormal returns between LBOs and business combinations, Torabzadeh and Bertin (1992) found that both forms of restructuring captured significant positive abnormal returns (even though the returns were larger for the business combinations). The tax shield created by an increase in leverage is also affirmed as a wealth gain to LBO transactions as evidenced by the work of Kaplan (1989) and Marais et al. (1989).

Most of the existing empirical evidence regard the motives of going-private based on an evaluation of the private equity wave of the 1980s in which LBO targets are compared against matched firms that are not undertaking an LBO. However, the more recent private equity wave, the LBO

Download English Version:

https://daneshyari.com/en/article/1003543

Download Persian Version:

https://daneshyari.com/article/1003543

Daneshyari.com