



## Private equity alliances in mergers <sup>☆</sup>

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### ABSTRACT

This paper examines reasons for alliance formation between private equity bidders when compared to sole-sponsored private equity deals. Testing a comprehensive set of hypotheses, we find strong evidence for the relative-risk hypothesis of Robinson (2008), as private bidders are more likely to form an alliance in a diversifying acquisition. We also find that private equity alliances involved more profitable target firms when compared to sole-sponsored private equity deals. Finally, we find that the significantly lower abnormal returns for target firms in private equity alliance deals are eliminated once we control for differences in the types of target firms acquired by private equity alliances and single private equity bidders. The last result suggests that private equity alliances do not generate significantly lower target returns because of collusion.

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### 1. Introduction

In the last decade, private equity firms' activity has increased substantially with capital commitments to U.S. private equity funds reaching 1.57% of market capitalization or over \$200 billion in 2007 (see Kaplan and Stromberg, 2008). In a seminal paper, Jensen (1989) argues that the publicly held corporation has been eclipsed by a relatively new organizational structure wherein equity is privately held, better corporate governance is practiced as management has a significant stake to align their interests with its owners, and firms have a much higher leverage ratio to restrict managerial interests from spending free cash flow.

One area of corporate governance practiced by private equity bidders that has come under increasing scrutiny is when two or more private equity bidders form an alliance or club<sup>2</sup> to jointly takeover a target firm. The Department of Justice has raised concerns about private equity firms submitting low bids in a club deal when taking over a public firm (Berman and Sender, 2006). Private litigation has also alleged collusive practices between private equity firms in rigging deal prices for target firms while disclosing revealing emails between private equity executives (Erman and Hals, 2012). One email exchange is revealing according to the complaint. Blackstone Group president Tony James to KKR co-founder George Roberts: "We would very much rather work with you guys than against you. Together we can be unstoppable, but in opposition we can cost each other a lot of money." Roberts in reply: "Agreed."

Accordingly, this paper makes the following contributions. First, we examine the economic reasons for why private equity bidders form alliances in some deals, and not in other deals. In doing so, we examine a comprehensive set of hypotheses<sup>3</sup> posited in the extant literature for alliance formation. Second, while controlling for target firm characteristics, we examine whether target firm shareholders of private equity firms who form an alliance between themselves earn lower, higher, or similar announcement

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<sup>2</sup> In this paper we use alliances and clubs interchangeably.

<sup>3</sup> See Section 2 for a more detailed explanation.

returns when compared to target firm shareholders of private equity firms who do not form an alliance. We control for target firm characteristics, because [Barger et al. \(2008\)](#) find that the target firms of private acquirers have significantly different characteristics than the target firms of public firms, and that such private acquirers pay less than comparable public firms.<sup>4</sup>

We find the following results. First, we find that the incidence of alliances in private equity (12.92%) is much larger than the incidence of alliances in public firms (0.69%). The latter result does not allow us to examine motives for alliance formation in the public bidder sample. Second, in the case of the private equity sample, we find strong support for the relative risk-reduction hypothesis of [Robinson \(2008\)](#) in that private equity alliances are diversifying acquisitions. We also find that private equity alliances are likely to involve more profitable target firms (at the 10% significance level), a result against the lemons hypothesis. Third, we find that the abnormal returns earned by private equity firms in alliances are significantly lower when compared to their sole-sponsored private equity deals. No such effect is found for public bidders. However, the lower abnormal returns earned by targets in private equity alliances disappear when one controls for the differences in target characteristics (using a propensity score methodology). A similar result is found when one uses interaction terms between private equity, alliance formation, and target firm characteristics. This suggests that private equity alliances do not earn significantly lower target returns once one controls for the differences in target characteristics between private equity alliances and single private equity bidders.<sup>5</sup>

The above results suggest that private equity firms do not indulge in bad corporate governance by paying a low price for target firms in a collusive organization form called an alliance or club. Instead, when compared to sole-sponsored deals, private equity alliances are formed to diversify their risk and to some extent (at the 10% level of significance) acquire more profitable firms.

The prior academic evidence shows mixed results. [Officer et al. \(2010\)](#) find that alliances between private equity firms earned lower announcement returns than sole-sponsored private equity deals. [Boone and Mulherin \(2011\)](#) find no significant differences when one controls for the firm's endogenous selection of forming an alliance. But these studies assume that the types of target firms chosen by private equity firms and public bidders are the same. We do not make such an assumption.<sup>6</sup>

In [Section 2](#), we present the various hypotheses that have been posited in the existing literature for alliance formation. [Section 3](#) describes our data and sources and [Section 4](#) presents our tests and results. In [Section 5](#), we conclude.

## 2. Determinants of strategic alliances between firms

The extant theoretical and empirical literatures on strategic alliances have suggested possible motives for alliance formation. We describe below these hypotheses and their corresponding proxy variables used (see [Table 1](#) for a summary).

### 2.1. Absolute-risk reduction hypothesis

The strategic management literature often advocates risk reduction as a motive for alliance formation in that firms are reluctant to finance high-risk projects internally.<sup>7</sup> Under the assumption of perfect capital markets, the financial economic literature would suggest that firm-level risk reduction activities are not optimal for diversified shareholders as they can diversify their own portfolios. Under different market frictions risk reduction can be valuable to shareholders. Several authors provide different characterizations of the frictions that may lead firms to hedge. First, firms might want to reduce their risk because of a convex statutory tax function (see [Graham and Smith, 1999](#); [Smith and Stulz, 1985](#)). Second, firms might indulge in risk reduction in order to minimize their expected bankruptcy costs (see [Adam et al., 2007](#); [Bessembinder, 1991](#); [Mayers and Smith, 1990](#); [Smith and Stulz, 1985](#)).

The absolute-risk reduction hypothesis stipulates a positive relation between target firm's risk and alliance formation between bidders. We use four proxies for the target firm's risk, with first two being general proxies of firm risk and the latter two being specific to taxes and bankruptcy costs. The first proxy is the firm's standard deviation of stock returns (*std\_ret*) calculated from 273 days before the announcement date to 20 days before the announcement date. The second proxy variable is the target firm's leverage ratio (*dratio*), defined as the ratio of total debt to assets in the fiscal year preceding the announcement date. The third proxy is the marginal tax rate (*trate*) of firms, defined as the present value of current and expected future taxes paid on an additional dollar of income earned today (see [Graham, 1996](#)). The fourth proxy is Altman's Z-score (*zscore*), defined as a firm's probability of bankruptcy.<sup>8</sup> If absolute-risk reduction is a possible explanation for alliance formation between bidders, we would expect a positive relationship between *std\_ret*, *dratio*, *trate*, and *zscore* and the probability of forming an alliance.

<sup>4</sup> We also confirm this result in our sample.

<sup>5</sup> These results of zero abnormal returns are also consistent with those of [Boone and Mulherin \(2011\)](#) but for two slightly different reasons. They attribute it to the endogenous choice of forming an alliance, where as we attribute to different target characteristics.

<sup>6</sup> [Kaplan \(1989\)](#), [Smith \(1990\)](#), [Lichtenberg and Siegel \(1990\)](#) and [Acharya, et. al \(2013\)](#) find significant improvements in the firm's operating performance and innovation when the acquirer is a private equity firm, whereas [Leslie and Oyer \(2008\)](#) and [Guo et al. \(2011\)](#) no significant improvements.

<sup>7</sup> See, for example, [Mody \(1993\)](#), [Nanda and Williamson \(1995\)](#), and [Folta \(1998\)](#). Under this hypothesis, alliances may be viewed as a real option. Companies may be interested in acquiring an activity, but do not want to commit fully until additional information becomes available. This option becomes more valuable as the risk of the environment increases.

<sup>8</sup> Specifically,  $z\text{-score} = (0.012 \times (\text{total current assets} - \text{total current liabilities}) / \text{total assets}) + (0.014 \times \text{retained earning} / \text{total assets}) + (0.033 \times \text{EBIT} / \text{total assets}) + (0.006 \times \text{market value of equity} / (\text{total long-term debt} + \text{debt in current liabilities})) + (0.999 \times \text{sales} / \text{total assets})$ . To control for extreme values we winsorize z-score at the 99% level.

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