5-2008

THE CREATION OF WEALTH FOR COMPANY STAKEHOLDERS THROUGH MANAGERIAL BEHAVIOR IN LEVERAGED BUYOUTS

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Undergraduate honors thesis under the direction of

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Submitted to the LSU Honors College in partial fulfillment of
the Upper Division Honors Program.

May, 2008

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Baton Rouge, Louisiana

ACKNOWLEDGEMENTS

I would like to express my utmost gratitude to my thesis advisor, Dr. K.C. Rakow, for his indispensable guidance and support during the process of deciding to write an honors thesis, narrowing down my topic to a feasible level, and conducting the scholarly research necessary for this final paper to materialize. I also would like to thank the members of my committee, Dr. George R. Wilson and Dr. Joni A. Nunnery, for their support and guidance during the refinement of this thesis.

Additional thanks is due to all those at the LSU Honors College for pushing students such as I to pursue world-class research in pursuit of an undergraduate degree. Specifically, I would like to thank Michael V. Blandino for all his patience the many times I dropped into his office to discuss my thesis. Thanks is extended to Dr. K.C. Rakow, Dr. David C. Hayes, and Dr. Kevin D. Melendrez for encouraging me to perform upper-level work in honors-option accounting courses. I would like to express admiration and thanks to Dr. Robert C. McMahon for providing inspiring honors course lectures that encouraged me to continue my education in the Honors College. Additionally I wish to thank Dr. Jeffrey C. Herndon for leading an honors seminar course that taught me the value of logic and reasoning applied to honors coursework and research at LSU.

Finally, thanks is given to central key people that are responsible for supporting not only this thesis but also the development of the person I have become during my undergraduate studies. Thank you, Mr. John Barreca for working diligently on your thesis and holding me accountable to completing mine; thanks for your constant friendship. Thank you, Patrick Holly, for mentoring me, befriending me, setting a precedent with your own honors thesis, and encouraging me to pursue my dream of going to law school. I would like to thank you, Pastor Charles Morton, for laying the foundation of my character and being my lifelong mentor. I

would also like to thank my father and mother, Ben and Lisa Clayton, for raising me to be industrious and believing in me. To my wife, Amanda, I extend thanks for constant support and affirmation during my work on this thesis; we should get jerseys because we’re such a good team. Most of all, thank you, my dear Jesus, my constant inspiration and the reason for everything I do.

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ABSTRACT

Since its inception following the Second World War, the leveraged buyout (LBO) has become the celebrity of large corporate takeovers. LBOs are business acquisitions that involve the acquiring companies taking on massive amounts of debt. The LBO has many criticisms: the potential for being a hostile takeover, the high possibility of financial distress, and losses to creditors of the buyout company. The LBO also has many supporters, touting such advantages as low required capital commitment, tax advantages, and improved corporate efficiency. One major claim of LBO advocates is that the LBO can be used as a tool to change managerial behavior, resulting in improved wealth for company stakeholders. The subject of this thesis is to examine whether or not the LBO actually changes managerial behavior in a way that creates wealth for company stakeholders.

This thesis topic has a high degree of relevance on several levels. To the U.S. business world, the LBO has been a growing phenomenon in the past two to three decades. It represents the extreme growth opportunities available to modern companies. There is a claim that this widespread acquisition phenomenon, the LBO, can improve managerial incentives to fulfill their obligations to shareholders, bondholders, customers and employees. This claim needs investigation, to determine if it had adequate substantiation. Additionally, this thesis topic is relevant to modern academia. Across all academic disciplines, there is the common element of humanity. We all need to understand human motivation and incentives. If the high amount of debt involved with such a prominent business topic as the LBO can change human incentives to benefit other involved parties, the LBO immediately becomes a very accessible and important topic. Even for the general public, there are strong implications of relevance: the financial markets today affect the quality of life across all strata of U.S. society.

CHAPTER 1

INTRODUCTION

Since its inception following the Second World War, the leveraged buyout has become the celebrity of large corporate takeovers. Certainly, anyone remotely familiar with mergers and acquisitions has heard the term "leveraged buyout." It is hard to ignore the phenomenon. The largest leveraged buyout in the United States, Kohlberg Kravis Roberts & Co.'s $31.4 billion purchase of RJR Nabisco in 1988, established renown for the leveraged buyout in the financial world and in the general public consciousness. The deal became eminent due to the storytelling of the book *Barbarians at the Gate*, also produced as a made-for-television movie (Alistair 34). As an acquisition phenomenon, the leveraged buyout has accounted for a significant portion of big business, comprising twenty percent of U.S. corporate takeovers, totaling $50 billion per year, in the 1980s (Baird 1). In the 1980s and 1990s, a total of $431 billion was raised by leveraged buyout funds (Olsen and Gagliano 1).

The popularity of the leveraged buyout in the business world is both remarkable and peculiar. This type of acquisition involves an acquiring company's choice to accept a massive amount of new debt to buy another targeted company. The decision to purchase another company is large enough, but the decision to take on multi-million or multi-billion dollar debt is even larger. A number of advantages of using debt to finance buyouts have been cited in the past: tax advantages, low capital commitment, synergy and efficiency gains, and the ability to positively affect managerial behavior. The lattermost of these advantages demands special attention. If a certain type of acquisition activity, namely, the leveraged buyout, can be used as a tool to cause optimal performance in company management, it has the potential for significant wealth creation.

The question of whether or not the leveraged buyout phenomenon creates wealth for company stakeholders lacks a definitive answer. Though advantages exist, critics point to the predatory nature of using leverage to finance acquisitions; leveraged buyouts can be hostile takeovers. Moreover, critics assert a heightened risk of financial distress for buyout companies and an unethical cost to company stakeholders, including bondholders, employees and customers. Conversely, proponents of the leveraged buyout assert that costs of financial distress are minimal and that improved managerial incentives result in wise investments of free cash flow (Opler and Titman 1985). Though the question of buyout wealth creation is multi-faceted, the implications of managerial behavior for possible wealth creation are conspicuous.

The present question is this: Is the effect of leveraged buyouts a change in managerial behavior that creates wealth for company stakeholders? In examining this question, the many possible effects of leveraged buyouts upon managerial behavior are to be explored. Management is construed broadly, to include top managers or administrators, such as executive board members; mid-level managers, such as department heads and district managers; and frontline managers, such as foremen, supervisors, and project leaders (Scott 4). The term "company stakeholders" is construed broadly, to include customers, employees, creditors, and other affected parties. In examining managerial behavior, three time periods are discussed: management facing the potential of a buyout; management following a buyout; and management facing an exit strategy after the buyout. Leveraged buyouts in the U.S. economy will be the primary focus. Before managerial actions can be discussed, a basic explanation of the leveraged buyout is necessary: its definition, its advantages and disadvantages, its characteristics, and its history. The first step in understanding a leveraged buyout is obtaining a working definition.

CHAPTER 2

LEVERAGED BUYOUTS IN GENERAL

2.1 Leveraged Buyout Defined

The term "leveraged buyout" is used widely in the modern business world. To define a leveraged buyout, it is important to look at the two constituent terms, "leverage" and "buyout." A widely-used business terminology website and Forbes Media Company, Investopedia defines a buyout as "the purchase of a company's shares in which the acquiring party gains controlling interest of the targeted firm" (*Buyout*). Leverage, in the business sense, can be defined in one of two ways. The first definition is "a method of utilizing others' assets (in the form of debt or equity) in an effort to produce a disproportionate increase in one's own investment and, coincidentally, overall worth" (Gargiulo and Levine 7). The second is "a means of ownership through borrowed or leased funds" (Gargiulo and Levine 7). Combining the definitions of the words "leverage" and "buyout" leads to an understanding of the term "leveraged buyout." A leveraged buyout could be either a purchase of a company's outstanding stock shares to produce a disproportionate increase in wealth or a purchase of a company's outstanding stock shares primarily through borrowed or leased funds. A leveraged buyout ends up meeting both of these definitions.

A leveraged buyout (LBO) is one company's purchase of all the outstanding shares of common stock of another company with a significant amount of debt capital and very little or no equity capital (Gargiulo and Levine 20 and Jarrell). An LBO can be either the acquisition of an entire company or a division of a company and either a public or private company. (Olsen and Gagliano 1 and Gargiulo and Levine 20). Buyouts of another company's stock have to be financed through, for example, issuance of more shares of common stock. What distinguishes

LBOs from regular buyouts is their high debt-to-equity ratios. LBOs commonly consist of ninety percent or greater debt, with the remainder being equity (Michel and Shaked 1). This debt capital is raised primarily through the bond issuance and loan financing. Another key feature is that the assets of the acquired, or target, company's balance sheet are used by the acquiring company as collateral for loans to finance the LBO (Gargiulo and Levine 20).

A leveraged buyout is a decision to go into debt. The LBO, a form of corporate acquisition, is generally initiated by a corporate management investigation and finalized by the approval of the board of directors, though an approval of voting shareholders is also required in some instances (Waldo 106). Specifically, a company goes into debt to buy a product, which is another company for sale. Companies for sale are widely available in the U.S. market today because suppliers, or corporations wishing to sell, divest one company for every two they buy (Gargiulo and Levine 21). Still, taking on long-term debt through bonds and loans is a weighty decision, and there are a number of commonly cited properties that make the LBO an attractive transaction for corporate buyers.

2.2 Advantages and Disadvantages of LBOs

On the most positive end of the LBO spectrum, there is the claim that most parties involved in an LBO are winners. Managers have the opportunity to become owners. Shareholders gain through receiving premiums above the market price. Lending banks can earn large returns and are secured against the acquiring company's bankruptcy through the promise of the sale of the collateral assets that the company acquires. Investment bankers and lawyers obtain high fees, since the LBO is a specialized area of knowledge for these parties to the buyout. (Michel and Shaked 3)

Not all business academics accept the belief that all parties in an LBO experience winning scenarios, but most accept that there are definite benefits for the buying company. The most eminent advantage is a company's ability to make a potentially multi-million or multi-billion dollar purchase without an immediate cash outlay. The debt financing of the LBO is attractive from the standpoint that there are tax advantages; the interest payments on the long-term debt are tax deductible. This so-called "tax shield" is comprised of the LBO's future tax savings that can be capitalized as future cash flows (Vunderink and van de Merwe 51). An LBO often involves a company buying its own stock to take the company private. This often results in several benefits: synergy gains by expanding operations into a new industry, efficiency gains through focus on meeting debt obligations, profit from the sale of split-up pieces of the target company, and freedom from scrutiny as a public company (Olsen and Gagliano 3, Value-Based Management, and Jarrell). Furthermore, managers can become owners of a significant portion of the post-LBO firm's equity (Olsen and Gagliano 3). As a result, an LBO can be a tool to affect managerial behavior, the main tenet explored by this paper.

For any number of these advantages to be achieved, an acquiring company must look for certain attractive qualities in an LBO acquired company, hereafter referred to as the "target company" or "target." The chief quality sought by the acquiring company is a "clean" balance sheet of the prospective target. Clean balance sheets have high asset balances in account receivable, inventories, machinery and equipment, and real property. These "hard" assets should be free of pledges to lenders; these assets will form the base of loan collateral (Olsen and Gagliano 4 and Gargiulo and Levine 31). Likewise, balance sheets of the target should have little debt because future cash flows will not be sufficient to service both old debt of the target and the new buyout debt from loans and bonds (Gargiulo and Levine 31). The debt incurred by

the acquiring company necessitates a target with steady, predictable cash flows and minimal working capital requirements (Olsen and Gagliano 4).

Assets and their usefulness are of the essence in making a company desirable as an LBO target. A potential target's stock performing poorly may be a signal of undervalued assets (Baird 3). The acquirer may see potential in such a target, in hopes of better using such assets to make a profit. For example, assets may be divestible; after an LBO, segments of the target could be sold for a profit. The Tuck School of Business at Dartmouth cites a number of other characteristics pertaining to use of assets: well-established market position, a strong management team, a feasible exit strategy, synergy opportunities, and the potential to reduce expenses (Olsen and Gagliano 4). These are target company characteristics that make companies possible LBO success stories, but not assured business triumphs.

As a matter of fact, uncertainty is only one of the factors that lead many to cite various disadvantages of LBOs and reasons they are harmful to the participants involved. For any business venture, there is the uncertainty of potential financial distress from unforeseen events, such as economic recession, litigation or changes in the regulatory environment (Olsen and Gagliano 6). Specifically, a business cycle recession can render a post-buyout company unable to pay the increased fixed costs resulting from higher interest payments on the long-term debt incurred in the buyout. Weak management is cited as the responsible party if a post-buyout company cannot survive such a recession (Olsen and Gagliano 6). LBO critics often mention that shareholders' stock price gains often come at the expense of other "stakeholders," like employees, bondholders and customers (Jarrell). They point out that target company employees have historically suffered income losses resulting from conflicts with acquiring company management (Jarrell). There is much debate over bondholders as "losers" in an LBO; critics

assert that shareholder gains come at the expense of holders of high-yield or “junk” bonds (Warga and Welch 960). Some will also mention that the federal government is a “loser” because of LBOs (Michel and Shaked 3). In the early years after a buyout, companies pay little to no income taxes because of tax advantages from depreciation and interest payments (Michel and Shaked 3).

Aside from profitability disadvantages, there are also ethical criticisms of the LBO phenomenon. In some cases, an LBO can be a “hostile” takeover. A potential acquiring company could buy all the outstanding shares of common stock against the wishes of the target company’s directors. Such a takeover is notably different from a merger, in which the target company’s board of directors and voting shareholders must approve (Jarrell). A potential target can be at risk of a hostile LBO if management owns an insignificant portion of company stock (Halpern and Kieschnick 281). A relevant counterpoint is that an LBO can be a defense against hostile takeover; target company management can buy all outstanding stock shares to thwart an outsider takeover attempt (Jarrell). The ethical criticism of an LBO as a hostile takeover is its predatory nature, namely the acquiring firm’s ability to use the target company’s success, measured by highly liquid balance sheet assets and strong cash flows, as loan collateral (Pan 3). Popular defenses against a hostile takeover include poison pills and state anti-takeover laws. Poison pills are company charter provisions allowing existing shareholders to either buy more stock shares or sell back to the company at an attractive price, diluting voting power of the hostile bidder. State anti-takeover laws involve the requirement of a waiting period between the purchase of a controlling stock interest in the target and formal completion of certain mergers and acquisitions (Jarrell).

2.3 Characteristics of LBOs

LBOs are clearly a complex and debated subject. A summary understanding of some basic structural characteristics is appropriate before LBO effects on managerial behavior can be explored. The main component comprising an LBO transaction is the debt, with the remainder being equity. The debt comes from a variety of sources. Senior debt includes commercial bank loans with repayment required in seven to eight years (Jin and Wang). Senior subordinated debt and subordinated debt are similar to senior debt, but the repayment period is extended to between nine and 12 years. Mezzanine financing is another term for high-yield bonds. High-yield bonds are often called "junk bonds" because the first such bonds were issued by risky companies in start-up industries, though in the late 1980s companies with good credit ratings began issuing such bonds to finance LBOs (Jin and Wang). The final category of LBO debt financing is bridge financing, which is short-term financing expected to be replaced within six months of the buyout (Jin and Wang).

The equity portion, though smaller than the debt portion, is still vital in completing the LBO transaction. A capital fund is used to invest this equity (Olsen and Gagliano 6). This fund acquires committed capital from institutional investors and individual investors. The individual investors must be defined as "qualified" by the Securities Exchange Commission (SEC) (Olsen and Gagliano 6). They could include such persons as entrepreneurs, incumbent management teams and investment bankers (Gargiulo and Levine 21). Institutional investors include such entities as corporate pension plans, insurance companies and private equity firms (Olsen and Gagliano 6-7). Venture capitalists have also begun to function in the institutional investor role; they have come to view LBOs as low risk and high return opportunities (Gargiulo and Levine

17-18). Private equity firms as institutional investors are especially vital, as they contribute twenty to forty percent of the total purchase price (Olsen and Gagliano 6).

The importance of obtaining debt and equity funding for an LBO is reinforced when one looks at transactions that fail from deficient funding. For example, in early 2008 a high-profile pending LBO failed. The renowned private equity firm Blackstone Group LP was unable to obtain the required funding to seal the acquisition of PHH Corporation. For such a renowned private equity firm to falter during a pending transaction could cast doubts on whether or not the firm can assemble the massive debt packages needed to finance LBOs (Cimilluca 1-3).

That some LBO transactions fail is an inevitable fact; the prices of LBOs are staggering. Most buyouts involve a premium on book. In fact, 75 percent of LBOs are a multiple of one to three times book value (Gargiulo and Levine 34). The winning bidder, the acquiring firm with the highest price offer, usually purchases the target company at so high a price that the resulting interest payments are of an imprudent amount (Michel and Shaked 55). Furthermore, market conditions affect the LBO price, as can be noted from a July 2007 LBO. The then pending deal, a purchase of Home Depot's HD Supply business segment, involved three private equity firms raising capital via a $4 billion loan from three banks (Program on Negotiation 5). Market conditions for both the banking and housing industries suddenly soured, making the equity firms less willing to pay full price to Home Depot and the banks less willing to loan the full amount to the bidding firms. The deal was only salvaged when the three firms, the three banks, and Home Depot agreed to renegotiate the terms of sale (Program on Negotiation 5). Negotiation of an LBO price is complicated enough to merit its own field of study.

A basic understanding of valuation of an LBO transaction is important because valuation determines the LBO price. It is difficult to value the target company because of various

estimates used in the calculation (Michel and Shaked 55). The simplest method involves summing the book value of all assets, subtracting the book value of all liabilities, and then dividing by the number of common stock shares outstanding (Michel and Shaked 42). Because the assets were recorded at historical cost, this type of valuation figure may be highly inaccurate. Plant, property and equipment would have the highest chance of understatement because the books may not reflect the much higher present value of replacement cost (Michel and Shaked 42). Market or replacement cost of assets is, therefore, often used as a valuation method, as is determining the worth of the target's component divisions or business segments if they were spun off and sold (Michel and Shaked 42, 44). Such market valuations involve market comparisons, which are metrics like multiples of revenue and Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Discounted cash flow analysis is also used to calculate the target's net present value from projected cash flows (Olsen and Gagliano 8). The valuation method chosen will significantly affect the price to purchase the target. Still, capital structure is important to a buyout's success because even if the price is reasonable, a poor capital structure can lower returns to investors by raising the likelihood and costs of financial distress (Kaplan and Stein 315).

Investors in LBOs are sensitive to such a possibility of financial distress. Generation of profits for these investors is the last fundamental structural characteristic of LBOs. Profit potential for several types of investors creates a high allure for LBOs (Michel and Shaked 140). Stockholders of the target sell their shares at a premium price (Michel and Shaked 170). Though these stockholders usually receive cash for the sale of their stock, they sometimes receive debt or preferred stock (DeAngelo 401). Lenders obtain generous front-end fees, and investors can often cash in their equity through a public stock offering within three to five years after the LBO

(Michel and Shaked 170). In successful LBOs, the equity holders receive high returns because they receive all capital gain benefits, while the holders of the high-yield or “junk” bonds receive fixed returns (Olsen and Gagliano 3). Individual and institutional investors that contribute to the LBO capital fund usually realize a return within three to five years of successful LBO transactions (Olsen and Gagliano 4). These returns are generated through carried interest, management fees and co-investment (Olsen and Gagliano 7-8).

An investor participating in an LBO should be aware that there are special types of LBOs. Other common names for a general LBO are “highly-leveraged transaction” and “bootstrap transaction.” As has been mentioned previously, some LBOs are hostile takeovers. A special type of LBO is an entrepreneurial buyout, in which there is a focus on a target in a technology-related industry, requiring technological knowledge to monitor the investment. The leveraged buildup (LBU) is a variation of the entrepreneurial buyout. It involves purchasing a small company or unit of a large company to be a platform upon which other small companies can be added in the future (Jin and Wang). Another special type of LBO is the management buyout (MBO); it involves a company in a mature industry that has shown little growth. Management believes stock is undervalued and buys out the company’s stock itself (Baird 3). The MBO will later be discussed in detail, as it has specific implications for managerial behavior.

2.4 Brief History of LBOs

The last topic providing a foundational knowledge of LBOs and their implications for managerial behavior is a brief LBO history. The leveraged buyout is a relatively new phenomenon in the U.S. business world. The first LBOs occurred shortly after the Second World War (Olsen and Gagliano 2). It was in the 1960s that LBOs began to gain recognition, as a supportive business environment offered problems for which LBOs offered potential solutions.

For example, there was a need for more consistent implementation of corporate governance guidelines (Olsen and Gagliano 2). The 1960s were a conglomerating decade, while the 1970s brought deconglomeration, creating a larger supply of companies as potential LBO targets (Gargiulo and Levine 11). Companies in the 1970s saw the opportunity to profit from inefficient and undervalued assets (Olsen and Gagliano 3). This is when the "bust-up" approach was conceived; LBO targets were companies that the acquiring firm would purchase and then break up into various business segments, to be sold for a profit (Olsen and Gagliano 3). This fascination with the LBO would only swell in the decade to follow.

The 1980s were a golden age for LBOs. Until then, LBOs of small companies were common; large companies became LBO targets in the 1980s (Jarrell). More than 2,540 publicly-traded firms with a market value exceeding $297 billion underwent an LBO between 1981 and 1989 in the U.S. During this same time period, LBOs comprised 7.5 percent of all mergers and takeovers numerically and 17 percent of all mergers and takeovers by value (Wiersema and Liebeskind 447). The number of LBO transactions skyrocketed in this decade, as well. In 1980 four LBOs occurred, with an aggregate value of $1.7 billion. In contrast, in 1988, there were 410 buyouts with an aggregate value of $188 billion (Value-Based Management).

LBOs became as popular as they did in the 1980s because of several changing market conditions. First of all, the high-yield or "junk" bond was invented in the 1980s by Michael Milken of Drexel Burnham (Jarrell). The growth of junk bonds led to their use as substitutes for bank debt for unknown companies either in start-up industries or without access to public markets for sufficient financing. By the late 1980s, companies with good credit ratings were issuing junk bonds to finance LBOs. (Jin and Wang). In general, public debt markets experienced rapid growth in this decade, opening up acquisition possibilities to borrowers that

would normally not be able to raise the millions of dollars in loans necessary to finance an LBO (Value-Based Management). There are several other factors cited as causes of spurred LBO popularity in the 1980s: relaxation of antitrust and securities laws under the Ronald Reagan presidential administration, the removal of state antitakeover laws by the Supreme Court in 1982, and restructurings and mergers due to deregulation of many industries (Jarrell).

The end of the 1980s suddenly brought a halt to the widespread success of the LBO. Very few LBOs defaulted on their debt obligations in the early 1980s (Jin and Wang). A study by Kaplan and Stein (1993) revealed that only one out of 41 buyouts in the early part of the decade defaulted on its debt (Kaplan and Stein 314). In contrast, the same study found that 22 of 83 buyouts defaulted on their debt obligations in the late 1980s (Kaplan and Stein 314). Bankruptcy resulted for many of these companies (Value-Based Management). There were $4 billion in junk bond defaults and debt moratoriums in 1989 (Jin and Wang). Kaplan and Stein's (1993) study states an "overheating" hypothesis: large capital flows into the LBO market created an excessive amount of financing for a finite number of deals, causing overpriced and recklessly structured LBOs (Kaplan and Stein 313).

The buyout bust continued into the 1990s, with the hope of recovery of highly-leveraged transactions returning near the end of the decade. The trend of increasing amounts of capital competing for the same number of deals continued to make target prices unattractive (Olsen and Gagliano 1). The equity market expanded to relieve companies of their heavy debt obligations in the early 1990s (Jin and Wang). By the mid-1990s, LBOs were on the rise again. More than ever, institutional investors, pension funds and high net-worth individuals provided capital for LBO funds. In the new millennium, potential targets willing to sell are accepting lower, more realistic valuations, an encouraging factor for acquiring firms (Jin and Wang). *Business Week*

(October 2000) asserted, “It may not be the glory years, but buyout shops are back, raising billions--and heading into uncharted waters.” (Sparks) U.S. firms are giving increased attention to potential LBOs on an international scale, especially in Europe and Asia (Jin and Wang).

2.5 Narrowing the Focus: Managers and Wealth Creation

Though the history of the LBO as a type of corporate acquisition is fraught with many complex issues, the question of wealth creation is paramount. Specifically, managers of companies that make leveraged purchases and managers of targeted companies are influenced to behave in certain predictable ways. Managerial actions during an LBO are strongly influenced by the presence of the buyout, and such actions significantly affect wealth creation for company stakeholders and for the national economy.

In order to investigate creation of wealth for company stakeholders resulting from managerial actions during LBOs, several categories of managerial actions will be discussed. There are three categories: management of the acquiring company and management of the target company before a potential LBO, management of the post-buyout company, and management of a post-buyout company pursuing an exit strategy. Managerial actions before a potential LBO create issues related to the attractiveness of the LBO target, the loss of job security, the threat of hostile takeover, the existence of value gaps, the extent of managerial stock ownership, and the valuation of the target. Managerial actions following the buyout mainly relate to the issue of the discipline of debt imposed on company management. The discipline of debt causes a host of managerial actions: a search for efficiency improvements to yield cash flows, budgeting and forecasting, the evaluation of company performance, monitoring of the possibility of financial distress, consideration of the debt’s contractual features, and actions that reduce agency conflicts. Managerial actions when a post-buyout company pursues an exit strategy depend upon the type

of exit strategy sought. Out of these several categories, the weight of the discussion falls upon post-buyout managerial behavior.

CHAPTER 3

PRE-BUYOUT MANAGERIAL BEHAVIOR

Though most of the empirical evidence and research on LBOs and managerial behavior is concerned with post-buyout managerial behavior, there are still important implications for pre-buyout management behavior. Before an LBO has been finalized, or when confronting the chance of a buyout, acquiring management and acquiree management are still two very separate entities. Acquiring company management and target company management have highly different motivations.

3.1 Attractiveness of Potential LBOs to Management

The first important issue regarding pre-buyout managerial behavior is a consideration of the attractiveness of an LBO to acquiring company and target company management. The important thing to remember is that an LBO involves a product: a company for sale (Gargiulo and Levine 21). Acquiring company management will find a purchase of the LBO "product" profitable under several conditions. These conditions include internal factors, such as good earnings, large backlogs and a high level of liquidity of the target (Gargiulo and Levine 14). The external environment can also encourage management to seek a target for its company to acquire. These external factors may include optimistic economic forecasts, a strong economy, low inflation rates, low interest rates, and easy credit conditions (Gargiulo and Levine 14). Specifically, management would be interested in LBOs of underachieving companies. Such management would assume they can do a better job making a target company earn according to its true capabilities (Gargiulo and Levine 29). This is especially true for MBOs. If the company has predictable cash flows but little growth and poor stock performance compared to other companies in the same industry, management might believe the stock is "undervalued" (Baird 3).

The belief in undervalued stock may make management willing to buy its own company's outstanding stock at a price substantially above market (Baird 3).

There are also conditions that would tend to make a company loathe the idea of buying out a target. If an LBO target requires substantial research and development (R&D) expenditures, capital equipment or working capital to produce an earnings stream, it will be avoided by acquiring company management. Management will also avoid LBOs of potential targets in developing or capital-sensitive industries (Gargiulo and Levine 29).

Given that corporate managers buy in good times, it is intuitive that corporate managers sell in bad times (Gargiulo and Levine 13). From the perspective of a potential target company's management, a poor product fit with company strategy could give management the incentive to sell a division or segment of a company by means of LBO. Additionally, management might be desperate for cash, leading to target management wanting to sell and being willing to sell at a low price (Gargiulo and Levine 25). Research shows that LBOs have historically increased the market value of target companies by thirty to forty percent and led to increases in operating profits (Wiersema and Liebeskind 447-448). The possibility of a target company's market value and/or operating profits increasing could make management agreeable to acquisition via LBO.

3.2 Fighting the LBO: Target Company Management

Conversely, there are sometimes strong reasons that potential acquisition could stir a potential target's management to zealously fight an LBO. The principal reason is that top management of a target company is often laid off after an LBO (Jarrell). This creates a conflict of interest, in that target company management may fight a pending LBO against the wishes of shareholders and other directors. As a result, management egos flare, with job security

threatened, and companies wanting to buy have to offer bids in excess of reasonable estimates of company value (Michel and Shaked 56).

Historically, LBOs have often involved bidders "going over the head" of management to seek control from target company shareholders (Jarrell). Some of these LBOs have been hostile takeovers. The modern possibility of hostile takeovers has led some to criticize LBOs as threats that force corporate managers to focus on short-term, rather than long-term, strategy (Jarrell). If this is truly the case, LBOs have caused managers to impair the economic vitality of their companies and the U.S. economy, though little to no empirical support for this assertion can be found. There is the argument that the modern managerial fear of hostile takeovers causes company restructurings that create large gains for shareholders (Jarrell).

Whatever the truth is on the threat of hostile LBOs either impairing or strengthening economic vitality, there is established proof of this threat affecting target company managerial actions. The "value gap" involving expected higher stock values after redeployment of a target's assets makes companies vulnerable to a hostile LBO (Jarrell). One management defense against this vulnerability is the MBO. Management buyout of the company prevents hostile bidding (Jarrell).

The level of target company managerial stock ownership affects the viability of an MBO as a defense to hostile bidders. There is significant competition for a bid if management holdings are small (Easterwood and Singer 512). A company with small managerial stock interest also makes it more vulnerable to hostile takeover (Halpern and Kieschnick 281). The inverse of these last two statements is also true. Therefore, in a company with low managerial stock ownership, management can resist increased competition and high vulnerability to hostile takeover through an MBO of the company (Halpern and Kieschnick 283).

3.3 MBO Problems

MBOs create special implications for managerial behavior prior to the completion of an LBO. First of all, there is a potential conflict of interest in managerial negotiation of the LBO price. Though management is the buyer of the target's stock shares, it is also responsible for negotiating their fair market value (DeAngelo 400). This duty to shareholders implies seeking out the highest possible company price, but managers often minimize their bids out of self-interest (Easterwood and Singer 512). Management in an MBO also has the incentive to forestall competitive bidding. Shareholders have several available mechanisms with which to thwart managerial underbidding. Directors, as bargaining agents for the shareholders, may actively seek rival bidders or encourage shareholders to vote against an MBO proposal. Additionally, shareholders can seek legal recourse, and large outside shareholders can form an alliance with an outside bidder to thwart the MBO bid (Easterwood and Singer 513). Often, independent valuation experts need more than mere market price to establish fair value. Pressure from these experts forces management to pay a premium on the stock, allowing a joint gain between the selling shareholders and buying management (DeAngelo 404).

Another problem with MBOs is that management has the incentive to manipulate earnings downward prior to an MBO (Cumming and Siegel 444). As previously mentioned, independent valuation experts, usually investment bankers, evaluate the terms of the price bid (DeAngelo 400). These investment bankers, and even courts, use earnings-based valuation methods to assess stock fair value, giving management the motivation to understate earnings and, consequently, LBO price. Accrual methodology is one method used by management in earnings understatement prior to the buyout (DeAngelo 400). Managerial earnings understatement makes

it difficult to assess overall historical LBO accounting performance. Some produce high returns on assets, while others produce more poorly after the MBO (Cumming and Siegel 444).

CHAPTER 4

MANAGEMENT OF THE POST-BUYOUT COMPANY

Evidently, behavior of target company and acquiring company managers is influenced by LBOs prior to finalization of the buyout transaction. This is only a small part of the picture, though. Most of the research shows that the most significant behavioral changes in management occur after the buyout and during the existence of the newly structured company, as long as it exists. As will be shown, the greatest effect of LBOs on managerial behavior results from high degree of leverage in the newly formed company. Management behaves in certain predictable ways to manage the high debt burden. Also, to be discussed is the relationship of LBOs to agency theory, as well as other relevant dimensions of managerial behavior.

4.1 The Discipline of Debt

Managerial behavior in an LBO company continues to be affected by the two structural components of debt and equity long after the transaction finalization. The debt and equity of the LBO transaction continue to affect capital and incentive structures during the life of the post-buyout company, hereafter referred to as the “LBO company” or “LBO firm”. The effects on capital and incentive structures can be summarized through a “carrot and stick” paradigm (Jin and Wang). The “carrot” is managerial incentive, which involves management-owned equity (Jin and Wang). In an LBO company, operating management owns ten to twenty percent of the company’s stock. Ownership of the company increases management’s incentive to work harder (Jin and Wang). Though managerial equity ownership will be discussed, the chief focus will be on the “stick.”

The “stick” is the LBO debt’s effect on managerial behavior. The “stick” is management’s obligation to service the large post-buyout debt through a focus on managing free

cash flow (Jin and Wang). The effect of high LBO debt to influence managerial decision making is commonly known as the "discipline of debt." Leverage, by nature, increases financial risk and amplifies the gain or loss realized by the LBO (Olsen and Gagliano 11). Management is aware of this risk and knows that effective leadership and diligent oversight are necessary for an LBO company to be successful (Gargiulo and Levine 22). It is called the "discipline" of debt because it does just that: an LBO disciplines management to efficiently manage cash flows that are less flexible than usual (Gargiulo and Levine 22). The ability of the target company assets to generate cash flows for debt servicing affects how severe this discipline will be (Olsen and Gagliano 3). Also, the ratio of the buyout price to the cash flows affects the severity of the debt discipline. This ratio rose significantly in the 1980s, due to an overheating phenomenon, especially for LBOs financed with junk bonds, though current-day high buyout prices also impose strict debt disciplines (Kaplan and Stein 313).

The discipline of debt is the largest aspect of managerial behavior for LBOs. Debt financing in LBOs becomes a tool for changing managerial behavior (Olsen and Gagliano 5). The strongest behavioral effects occur in the first few years after an LBO, when the exposure to financial distress of the company is highest (Jarrell). The need to make principal and interest payments forces a managerial focus on operating efficiency improvements. Common managerial initiatives to increase operating efficiency in LBOs have included downsizing, cost-cutting, investing in new technologies, and divesting non-central businesses (Olsen and Gagliano 5). Management also seeks to tighten financial controls and find new sources of cash flows (Gargiulo and Levine 28, 32). Assets with "hidden values" will be sought and sold, including "real estate, excess machinery and equipment, obsolete and excess inventories, product lines, divisions, and so on" (Gargiulo and Levine 32). Corporate expenses deemed wasteful will be

eliminated, as well. As management makes these operational improvements, shareholder wealth increases (Jarrell).

The increase in value to shareholders through managerial actions is linked to managerial financial fears and concerns in a buyout company. Management is very dedicated to the debt discipline because if the company cannot make interest payments when scheduled and eventually repay the principal, the company will be liquidated. Briefly stated, managers have the incentive to improve efficiency because the company faces bankruptcy if the debt is not serviced (Nikoskelainen and Wright 512). These improvements in various measures of operating efficiency are, however, only one aspect of firm value. Management will need to focus on long-term prospects, as well (Nikoskelainen and Wright 513).

4.2 Debt Servicing Via Efficiency Improvements

There are numerous methods used by LBO company management to improve efficiency and, thereby, service debt. The present discussion concentrates on several trends in managerial operational decisions that are intended to service LBO debt. These trends are the sale of unprofitable divisions, avoidance of low-return investments, elimination of wasteful expenses, outsourcing of intermediate goods and materials, reduction of employment growth rates, and the growth of core and periphery businesses.

4.2.1 Managerial Sale of Company Divisions

In an LBO company, management often seeks to sell unprofitable divisions (Jarrell). Many of these divisions are from the acquired company and are sold shortly after the buyout. There is an immediate need to repay loans to certain lenders who negotiated the rights to call their loans upon a change in the company's corporate form (Baird 4). The acquiring company, which obtained these loans, incurred a change in corporate form through buying out another

company. The LBO, therefore, makes the loans callable. To immediately pay back the large principal amounts of such loans, management has the option of selling target divisions.

The target divisions chosen by management for sale are chosen using various criteria. Divestitures may include divisions that are not performing well, not vital to the LBO company's core business, or worth more as a separate entity than as part of the LBO company (Halibozek and Kovacich 221). Target divisions chosen by management for sale are often portions no longer necessary for business or not aligned with the long-term strategic objectives of the post-buyout company (Halibozek and Kovacich 222). A prime example of business divestiture of units unaligned with long-term strategy is Westinghouse Corporation. In the 1990s, Westinghouse owned businesses including a defense system division producing military and government products, nuclear power plants for generating energy, and broadcasting and media divisions. The company divested all business units not related to media and broadcasting and, after acquiring CBS, even dropped the name "Westinghouse," which had been its historic brand name (Halibozek and Kovacich 222-223).

The type of business division sold by LBO company management can create unique circumstances, depending on whether the division is stand-alone or fully integrated. If the business unit is a stand-alone division, it operates with a great deal of independence. It will be more easily separated because of fewer attachments to systems and processes of the selling company (Halibozek and Kovacich 226-227). Management overseeing the transition of selling the division will have an easier job than if the division is fully-integrated with the company. If the division being sold is fully-integrated, the divestiture will be much more complex and time-consuming. (Halibozek and Kovacich 226-227). Specifically, if the division is fully integrated with the primary information system of the company, it could be very expensive (Halibozek and

Kovacich 227). This would make management's job more difficult. In either type of divestiture, there is a high amount of people, physical assets and information leaving the divesting company and migrating to the acquiring company during a separation period. During this period, management is responsible for security, namely, ensuring that only assets declared part of the sale are transferred to the buyer (Halibozek and Kovacich 234).

4.2.2 Managerial Avoidance of Low-Return Investments

Another method of producing the cash flows necessary to service debt is to avoid low-return investments (Jarrell). It is intuitive that managers would favor investments that provide high returns, and resulting high cash flows, to service debt. It is important for managers to seek investments that do not merely yield a profit, but also result in adequate cash flows collectible within a reasonable time period (Joabar 37). This makes the projection of cash flows vital. Consideration of investment choices should involve the minimum investment amounts required to receive the required rate of return, as well as the lengths of time necessary to pay back any debt associated with investment choices (Joabar 37). Risk must be taken into consideration; income can be boosted through risks, only if they are prudent (Kosnett and McGrath 40). Managers are responsible for knowledge of not only benefits of the investment choices but also contingencies involved. Managers often diversify investments to include lower-yielding investments that have resulting lower risks (Kosnett and McGrath 40).

In managers' quest to seek high-return investments to produce adequate cash flows for debt payments, internal and external analyses are necessary. Risks may be taken to the extent that they are appropriately correlated with the business and industry environments. For example, investments may include new ventures like new products or targeted market segments (Kornik 32). There is a current trend in the business world to use new products and new customers to

fuel company growth, especially in sales organizations. These companies are required to make a significant initial investment before reaping any returns (Kornik 32). Another managerial decision is the extent of investment in highly liquid assets, such as treasury securities (Kim and Mauer 336). Compared to other investment opportunities, holding highly liquid assets results in a low rate of return, which is costly to the company. Even so, management may decide to hold a high percentage of liquid assets because of the costliness of external financing and the uncertainty of future internal funds (Kim and Mauer 336). With each investment alternative, management faces both expenses and cash flow opportunities.

4.2.3 Managerial Elimination of Wasteful Expenses

Management seeking to produce the cash flows necessary to service LBO debt is likely to eliminate wasteful corporate expenses (Jarrell). Though opportune market conditions may provide growth prospects for the company, management should avoid excessive expenditures that deplete cash reserves (Joabar 36). Management has the incentive to avoid such expenses after an LBO because of the importance of cash flow for debt servicing. Though sales and profit margins are significant, these measures may not reveal if cash flows are sufficient to ensure business continuity. The management of steady cash flows is largely accomplished through managing expenses and cutting unnecessary ones (Joabar 36). Management has the incentive to locate these wasteful expenses. One such category of wasteful expenses can be certain fixed expenses. Though expansion of the company should only be sufficient to cover predictable and recurring needs, management sometimes incurs excessive fixed expenses through overexpansion. For example, management would normally be tempted to move operations to a larger facility, but could avoid this expense through better utilization of existing space (Joabar 36). On the

purchasing side of the business, management could negotiate payment terms with vendors to allow deferral of payments or to take advantage of discounts for paying early (Joabar 37).

4.2.4 Managerial Outsourcing Decisions

The next relevant method used by management to produce the cash flows necessary to service debt is the outsourcing of intermediate goods and materials (Jarrell). Outsourcing is defined as "the procurement of goods and services from external suppliers" (Mol 5). Such outsourcing reduces the labor intensity of production, improving economic performance (Cumming and Siegel 454). LBO company management may directly transfer certain company assets, such as machinery, buildings, or stocks of products, to suppliers (Mol 23). The investments associated with these assets are then redeployed to increase investments in activities that increase company revenue streams. These revenue streams are used to make debt payments (Mol 23). In addition to providing more money to invest in revenue-producing activities, outsourcing reduces company costs.

LBO company management tends to favor outsourcing mainly for its reduction in production costs. Outsourcing helps companies create cost leadership advantages through selecting the cheapest suppliers of various activities from the marketplace (Mol 161). External suppliers, due to specialization in production of certain components, can produce at lower costs than the outsourcing company. LBO company management outsources non-central activities, reducing fixed costs and lowering break-even points, which increases profits (Mol 24). This results in redirection of managerial attention to a smaller set of activities; management focuses on core competencies (Mol 23-24). Company activities with weaker resource bases are most likely to be outsourced (Mol 161). Still, buyout company managers have to handle outsourcing decisions carefully. Outsourcing involves social costs, organizational upheaval, and a degree of

experimentation (Mol 159-160). Company employees can feel that they are the object of such experimentation, if management does not carefully guide outsourcing decisions (Mol 160).

4.2.5 Managerial Reduction of Employment Growth Rates

There is a tendency for debt service to be managed by downsizing. In general, studies have shown that companies with high debt aggressively downsize by terminating employees (Burke and Cooper 7). Downsizing occurs because of the rationale that future costs are predicted more easily than future revenues (Burke and Cooper 11). Cutting costs, therefore improves profits; and human resources are a high portion of these costs. As a result, managers terminate employees, anticipating "lower overhead, less bureaucracy, faster decision making, smoother communications, greater entrepreneurship, and increased productivity" (Burke and Cooper 11). The 1990s saw increasingly frequent use by management of downsizing to cut costs. That decade saw two trends: a more streamlined workforce as a measure of company competitiveness and forced competition among company subsidiaries (Beynon and Grimshaw 237). The 1990s also presented numerous opportunities to cut labor costs: direct cutting of wage rates, forcing middle managers to have high level responsibilities without pay adjustments, layers of management removed, and reduction of additional payments for working extra hours (Beynon and Grimshaw 238).

Though used by managers in LBOs, downsizing often does not allow the company to reach these hoped-for financial objectives. Apparently, the high level of debt causes LBO company management to seek the fastest solution, which may be downsizing. The argument has been made that downsizing after an LBO corrects past unprofitable expansion (Wiersema and Liebeskind 449). Sometimes, management achieves notable benefits through downsizing: heightened worker aspirations, strengthened link of pay with performance, increased investment

in training, improved communication, encouraged innovation, and a clearer mission (Burke and Cooper 13). Still, management will not be willing to abandon all previous investment in the workforce structure because this structure represents a large investment (Beynon and Grimshaw 30). Whether or not managers service debt through downsizing employees, they often will change the size of certain lines of business.

4.2.6 Managerial Actions Affecting Core and Periphery Business Growth

Management's need to handle the high amount of buyout leverage leads to consistent trends in the growth of the company's core and periphery businesses. Typically, public company managers have the incentive to expand businesses, which constitutes an inherent expansion of company size, but not necessarily company value. Downsizing periphery businesses increases firm value, and downsizing core businesses increases firm value if management has "overexpanded" the company (Wiersema and Liebeskind 450). The incentive-intensity theory asserts that LBO company management tends to agree with downsizing, or reducing growth, of both core and periphery business (Wiersema and Liebeskind 450). LBO company management is more willing than typical public company management to reduce growth because the extra cash flow available through slower growth can be used to make debt payments.

Related to the trend in LBO management reducing growth is a trend in LBO management changing the portfolio of periphery and core businesses. On average, public company managers are willing to add peripheral businesses and are resistant to divesting existing peripheral businesses, when incentives to expand company size exist (Wiersema and Liebeskind 450). These peripheral businesses are characteristically unrelated to the company's main line of business, and resultantly impose costs from lack of synergies. Divesting these peripheral businesses reduces these costs, increasing company value. LBO managers, according to the

incentive-intensity findings, have the willingness to divest these peripheral and resist adding new peripherals (Wiersema and Liebeskind 450). This results in increased firm value, increased cash flow, and increased ability to service LBO debt.

4.3 The Incentive to Focus on Planning and Monitoring

From selling unprofitable divisions to divestiture of periphery businesses, management behaves in a variety of ways known to make the operational efficiency improvements necessary to increase cash flows to pay off LBO debt. In addition to bringing a focus on efficiency, LBOs influence management to focus on planning and monitoring activities to meet the discipline of debt. It is important to understand the types of planning and monitoring activities used by management. These activities include budgeting and forecasting, evaluating key ratios of company performance, and continuously monitoring the possibility of financial distress.

4.3.1 Managerial Monitoring of the Possibility of Financial Distress

Continuously monitoring the possibility of financial distress, especially within the first few years following the buyout, is a managerial priority. A "bad year, a bad quarter, a bad month, can kill" a post-buyout firm (Gargiulo and Levine 33). An unforeseen event can eliminate the company's ability to make an interest payment for a certain time period (Value-Based Management). When a company starts missing interest payments, it faces bankruptcy (Nikoskelainen and Wright 512). Though management cannot predict unforeseen events, it can understand that the profitability of the LBO company is related to the profitability of other financial markets and affected by other business cycles (Jin and Wang). Management, therefore, is motivated to monitor the possibility and existence of economic recessions, litigation, changes in the regulatory environment, seasonal fluctuations, competitive impacts, and pricing (Olsen and Gagliano 6 and Gargiulo and Levine 30-31). LBO companies with unique products requiring

future service incur the highest costs in a period of financial distress (Opler and Titman 1989). Managers of this kind of LBO company will be the most sensitive to monitoring the environment and its correlation with the nature of the entity.

4.3.2 Managerial Budgeting and Forecasting

Along with monitoring business cycles and other conditions, LBO management is forced to plan the company's business continuity. Planning activities involve budgeting and forecasting (Gargiulo and Levine 31). Budgeting forces management to determine goals and objectives and to develop a plan to achieve them (Woelfel 30). LBO company management will have to focus on both operating and financial budgets, to achieve performance targets. Performance budgeting is especially important because of the need to use resources to meet not only an amplified debt burden but also regular operations. The principal focus of performance budgeting is improving efficiency through activity classifications and cost measurements (Woelfel 37). Budgetary control is also important; managers have to evaluate budget variances and communicate budgets to individuals who are assigned performance responsibilities (Woelfel 31). Budgeting has to be coordinated with forecasting, which is the estimation of future business activity according to secular trends, seasonal variations, cyclical fluctuations and random fluctuations (Woelfel 135). Managers rely on more than one method of forecasting. Managers can use qualitative methods, including the Delphi method of group brainstorming, as well as causal methods that use independent variables to predict a relationship with dependent variables. Regression models are also used in time series methods (Woelfel 138). Whatever budgeting and forecasting processes are used, they must be chosen based on their ability to allow the company to survive and thrive with a high degree of leverage.

4.3.3 Managerial Evaluation of Key Ratios of Company Performance

As LBO company managers budget and make forecasts, it is important to continually measure actual performance compared with standards. Key performance indicators (KPIs) are especially useful in measuring actual performance. KPIs are quantitative measurements of firm performance compared with firm objectives and goals. The ability to meet loan contractual obligations and bond obligations in an LBO company is often measured by financial ratios (Kaplan and Stein 315). Two important ratios for management are the debt-to-equity and interest coverage ratios. The debt-to-equity ratio is equivalent to total liabilities divided by shareholders' equity; it communicates the amount of debt per dollar of shareholders' equity. Banks that make the original loans to the acquiring company before the buyout often use debt-to-equity as a factor in offering a loan (Berman and Knight 159). It is, therefore, advantageous for management to continue to monitor debt as a percentage of equity during the period of the loan(s). The interest coverage ratio, equivalent to operating profit divided by annual interest charges, is also useful. It tells management how much interest must be paid per year, relative to the company's ability to pay (Berman and Knight 160). Though important, these ratios are insufficient measures of leverage, on their own. The monetary amount of the debt burden is not the only factor involved (Kaplan and Stein 315).

4.4 Managerial Consideration of Debt Contractual Features

Management must consider the debt's contractual features, including seniority and maturity (Kaplan and Stein 315). Maturity varies with each lender and requires that management be aware of the order in which loans reach maturity, requiring repayment of principal. Seniority of debt is described by the type of debt offering. LBO debt types are generally either senior debt or mezzanine financing (Olsen and Gagliano 5). Senior debt includes loans that have repayment

priority over other debt obligations of the company. Beneath senior debt is subordinated debt, a debt offering that pays lenders only after senior debt lenders have been repaid (Culp 11). Mezzanine financing is a hybrid form of debt capital that may give the lender the right to convert a debt instrument to an equity interest, and it is a form of subordinated debt (Culp 296). In addition to senior and subordinated debt and mezzanine financing, bridge financing is sometimes listed as a category of LBO debt. Bridge financing is short-term financing expected to be replaced within six months of the buyout (Jin and Wang). The seniority structure of LBO debt is based on the concept of subordination.

Subordination is the priority given to a lender in the case of the borrowing company's bankruptcy. In an LBO, different lenders to the company have differing levels of priority as claim holders, in the event of the company becoming insolvent and the proceeds from liquidation of company assets being distributed (Culp 9). Lenders with the highest seniority have the lowest subordination, lowest default risk, and first priority of being paid off if the LBO company goes bankrupt (Culp 9-10). The most subordinated claimant of the LBO company is actually the equity holder, who receives nothing from the insolvent company, unless all other debt holders have been made whole (Culp 10). Slightly less subordinated than equity is subordinated debt, which is borrowing that distributes a pro rata share of cash proceeds from liquidated assets, only after senior lenders have been paid off. Subordinated debt can have several levels, including bank loans and public or institutional investing (Culp 11). The riskiest subordinated debt may include junk bonds. The least subordinated is senior debt, often bank loans made directly by commercial banks to LBO companies; senior debt holders have the least risk since they are paid off first if the company goes bankrupt (Culp 11). Though current research has few empirical findings about how seniority and subordination of LBO lenders affects company management,

one can intuitively state that management will be obliged to be knowledgeable about financing structure. Management is responsible for knowledge of the company's risk of bankruptcy and the company's priority of repayment of principal and interest to lenders.

A special type of subordinated debt may have special implications for LBO company management. Subordinated debt can sometimes include mezzanine financing, a debt obligation unique to buyouts and acquisitions. A hybrid form of debt, mezzanine financing often has an interest rate closer to a return on equity than the rate on senior debt, and it may be issued in the form of preferred stock (Culp 296). Mezzanine financing often includes high-yield bonds (Jin and Wang). It can be subordinated to senior lenders via either blanket or springing subordination provisions (Culp 296). A blanket mezzanine debt lender receives no principal or interest payments from the borrowing company until senior lenders are paid in full. Holders of springing subordination mezzanine debt receive interest payments, as long as the LBO company does not default on senior debt loans. If the company does go bankrupt, mezzanine debt holders stop receiving interest payments until senior debt holders have paid off (Culp 296). If LBO debt includes blanket mezzanine debt, company management will focus on repaying senior lenders and will not make principal or interest payments to the mezzanine lenders. If, on the other hand, LBO debt includes springing subordination mezzanine debt, management will still be responsible for making interest payments to mezzanine lenders.

Mezzanine lending and senior and subordinated debt, subject to the concept of subordination, may involve the process of syndication. A loan may be syndicated, containing a single set of terms, but containing multiple lenders providing funds to the LBO company (Lucas and Goodman 44). Common to LBO deals, syndication allows the borrowing company to negotiate loan terms once and access multiple lenders (Lucas and Goodman 46). The resulting

credit agreement is structured by a commercial or investment bank, known as the "arranger" (Lucas and Goodman 46). The credit agreement includes a revolving line of credit, which allows managers to use funds on a changing basis each month, and several term loans, which have differing maturities (Lucas and Goodman 48). Additionally, the credit agreement distinguishes between pro rata and institutional loans. The former are usually bank loans with maturities in three to five years, and the latter are usually non-bank institutional investor loans maturing in five to seven years (Lucas and Goodman 48). Management is responsible for an awareness of servicing debt according to the credit agreement and giving priority to lenders with earlier maturities.

4.5 Managerial Consideration of Specific Loan Terms

LBO company management's responsibility regarding credit agreements is to properly address loan terms. Loan terms, listed in credit agreements, include the borrowing company's representations, warranties and loan covenants (Lucas and Goodman 53). The purposes of loan terms are to preserve collateral, appropriate excess cash flow, control business risk, require reporting during the time loans are outstanding, and require certain performance standards to be met (Lucas and Goodman 53-54). It is important to discuss each of these purposes of loan terms and their implications for managerial behavior.

The preservation of collateral is the first main issue addressed by loan covenants between lenders and borrowing LBO companies. When an LBO company finances the buyout, assets are used to secure the loan. This could include all company assets or specific company assets (Lucas and Goodman 54). The company is not permitted to pledge this asset collateral to other creditors during the period of outstanding LBO loans (Lucas and Goodman 55). Management, therefore, cannot sell any assets is chooses after an LBO, nor can management pledge assets as collateral in

obtaining other financing. Because LBO managers are responsible for maintaining asset collateral, they will follow certain asset maintenance procedures to accomplish this. For example, fifty percent of inventory and eighty percent of receivables are generally able to be used in financing (Lucas and Goodman 54). Additionally, managers will need to focus on paying taxes to prevent governmental authorities from acquiring an overriding claim on asset collateral pledged to lenders (Lucas and Goodman 55).

The next loan covenant issue is the appropriation of excess cash flow. Loan covenants usually require excess cash flow from LBO companies' business activities to be used to pay off loans early (Lucas and Goodman 55). Excess cash flow is defined as "cash flow minus cash expenses, required dividends, debt repayments, capital expenditures, and changes in working capital" (Lucas and Goodman 55). Depending on the loan covenant, the LBO company may have to pay a certain percentage of this excess cash flow to lenders, even if it exceeds regular interest payment obligations (Lucas and Goodman 55). Loan covenants, therefore, imply that LBO company managers will have necessary restrictions on their use of cash flow.

A third purpose of loan covenants is to control the LBO company's business risk. If an LBO company declines in value, it may face the risk of default on loans, which would require liquidation of the company. In the case of case of loan default, equity holders will receive zero residual value because of their high degree of subordination in the company's capital structure (Lucas and Goodman 55). Equity holders would prefer managers to make risky business investments with the chance of high returns, in the hope of at least receiving some residual value after senior lenders have been repaid (Lucas and Goodman 55-56). Loan terms, however, often prevent the company from taking on more risk through investments (Lucas and Goodman 56). Once again, loan covenants place restrictions on managerial use of company cash flows.

A major provision of loan covenants, the reporting requirement, assists lenders in monitoring borrowers (Lucas and Goodman 57). During the outstanding periods of loans to LBO companies, the companies must supply reports and documents to the lenders. The chief requirement is to provide quarterly and annual financial statements (Lucas and Goodman 57). In addition to company management providing financial statements, management will be responsible for providing budgets and financial projections; accounts receivable analysis; property, plant and equipment appraisals; proof of insurance; and other information to lenders (Lucas and Goodman 57-58).

The last purpose of loan covenants, to establish performance requirements, provides management with a strong incentive to be concerned for bondholder and other lender interests. In the 1980s, there was the "overheating" phenomenon of investors pouring excessive money into the LBO junk bond market, driving up prices and changing LBO financing structures (Jin and Wang). Ever since, these higher LBO prices have been correlated with LBOs in riskier industries. Banks making loans to acquiring buyout companies realized this increased risk in the LBO market and began changing loan repayment schedules to require more frequent and faster payments (Jin and Wang). Lenders to LBO companies have continued to hasten repayment schedule of principal, resulting in much lower ratios of cash flow to total debt obligations (Kaplan and Stein 313). These "event risk covenants," also known as "poison puts," are contractual provisions creditors have for LBO companies (Baird 1). The acceleration of principal payments is required if there is a dramatic change in company capital structure (Baird 1). Also, violations of performance requirements can give lenders the right to make a loan payable immediately. These requirements are based on accounting measures of coverage, leverage, liquidity, tangible net worth, and maximum capital expenditures (Lucas and Goodman

56). These measures may include the interest coverage and debt-to-equity measures, discussed earlier. In LBOs for which the company's creditors have event risk covenants, management will have to use available resources to fund increased payment of principal. Managers also have the incentive to follow generally accepted accounting principles and use appropriate performance measures, to avoid mandatory immediate payback of loans.

Even more specifically, LBO creditors that are bondholders may have additional claims to company cash flows. Bondholders' rights are governed by fraudulent conveyance law, which states that bondholders have the legal right to object "if the transaction leaves the firm less valuable and either insolvent or with an amount of capital that is 'unreasonably small'" (Baird 2). Though there is little empirical evidence as to how fraudulent conveyance law would affect LBO managerial behavior, there are logical implications for managerial incentive to protect bondholder rights.

4.6 LBOs and Agency Theory

LBO management's obligation to focus on repaying creditors is not to the exclusion of focusing on the company's obligation to shareholders. General business knowledge would allow one to understand a company's first obligation is to its shareholders, who are the company's owners. In an LBO company, this obligation not only continues to exist, but also has special managerial implications regarding agency theory.

Agency theory presents the case that in public corporations, there is an inherent conflict between the goals of professional managers and stockholders (Phan and Hill 705). One source of this "agency conflict" is the utilization of free cash flow, defined as cash flow in excess of cash required to fund all investment projects "whose forecasted financial return is positive when discounted at the relevant cost of capital" (Phan and Hill 705). Arguably, this free cash flow

could or should be distributed to shareholders by means of dividends or stock buybacks (Phan and Hill 705). Agency theory predicts that managers resist such distributions of free cash flow to shareholders. Instead, managers of public companies favor investment in projects that expand the company size and that may yield low or negative returns (Phan and Hill 705). Suggested mechanisms, such as the board of directors, managerial stock ownership, and stock option plans, have been suggested to reduce agency conflict. These mechanisms are insufficient means, on their own, to reduce agency conflict (Phan and Hill 706).

The leveraged buyout is one proposed means of reducing agency conflict (Phan and Hill 706). First of all, agency costs of "overinvestment" are reduced in LBO companies, which tend to reduce excessive capital expenditures after a buyout (Wiersema and Liebeskind 448). Additionally, LBO corporate governance mechanisms reduce agency costs through improved operating efficiency to avoid bankruptcy from inability to pay off debt (Nikoskelainen and Wright 512). With agency conflict reduced, management services high debt payments, instead of wasting free cash flow. As has been discussed previously, servicing debt payments leads to managerial actions that are efficient: cutting unsound investments, reducing overhead, disposition of certain assets, and restructuring the company's organization to increase accountability and control (Phan and Hill 706). In discussing agency theory and the LBO, there is a need to discuss specific managerial incentives created by the LBO and how these incentives lead to actions that increase firm value and value to shareholders. These incentives include the motivation to increase firm value, diversify, decentralize, and reduce hierarchical complexity. Also, there is a necessary discussion of the effect of managerial equity ownership in LBO companies and how the monitoring of management is affected.

4.6.1 Managerial Incentives Regarding Company Value vs. Company Size

The first area of managerial motivation affected by a leveraged buyout is the incentive to focus on increasing firm value, rather than on increasing firm size. Though company growth is a viable method of wealth creation, such corporate size increases must include the selection of solutions that contribute to the company's long-term financial health. On average, public company managers emphasize sales growth, market share, and other measures of firm expansion because their usefulness is defined by status, power, income and job security, all of which are functions of the company's size (Phan and Hill 708). When managers increase firm size, they receive compensational rewards (Wiersema and Liebeskind 448). As a result, managers may undertake value-reducing unprofitable ventures that increase their compensation. Unfortunately, the board of directors often lacks the constitutional rights to limit such indiscretionary managerial actions. Additionally, in most public corporations, there are numerous shareholders, each with little wealth at stake, resulting in reduced oversight of management (Wiersema and Liebeskind 448). The LBO is proposed as a means of restoring a managerial focus on firm growth that will not only improve managerial compensation but also increase firm profitability (Phan and Hill 708). LBOs, especially going-private LBOs, provide more intense incentives for managers to choose only growth strategies that increase firm value. These incentives result because opportunities for compensation and advancement are linked with the "stick," payment of buyout debt, from the original "carrot and stick" analogy (Jin and Wang and Wiersema and Liebeskind 448).

4.6.2 Managerial Incentives Regarding Diversification

The evidence regarding LBO managers' incentives to diversify is not as apparent as evidence regarding incentives to increase firm value. The evidence is, however, still present.

Diversification, or company expansion into new branches of business, can have several forms and underlying reasons.

A certain amount of diversification is recognized as positive for a publicly-traded company. Company value is measured by the ability to sustain competitive advantage through cost advantages or product differentiation (Wiersema and Liebeskind 450). Cost advantages and product or service differentiation can be achieved through a certain amount of diversification that is related somehow to the company's main line or lines of business. Such "related diversification" allows sharing of assets like production capacity and proprietary technology and increases company value (Wiersema and Liebeskind 450). To the extent than an LBO involves the purchase of a company that will allow such related diversification, there are probable synergy gains, allowing expanded operations outside the acquiring company's immediate industry or line of business (Value-Based Management). Managerial implications of related diversification enter the scene after the buyout occurs. The high level of buyout debt causes managers to reenter credit markets to start new ventures. These diversifying new ventures subject managers to greater public scrutiny than investments of cash flows into internal projects (Baird 8-9). Intuitively, one can observe that this greater scrutiny would tend to improve managerial behavior and reduce agency conflict.

Though managerial increases in related diversification increase firm value, many public company managers waste free cash flow through diversification beyond the point at which efficiency is achieved (Phan and Hill 709). Agency theory teaches that managers often have incentives to undertake unprofitable ventures that reduce firm value (Wiersema and Liebeskind 448). These unprofitable ventures are often the result of "unrelated" diversification. Unlike related diversification, unrelated diversification is, by definition, "not based on shared

technologies, production processes or customers" (Wiersema and Liebeskind 450). Studies show that related diversification causes companies to economically outperform firms with unrelated diversification (Wiersema and Liebeskind 450). Also, firm value increases with the disposal of unrelated business units. In spite of these facts, public company managers have the incentive to diversify in unrelated business units because of resulting increases in firm size, leading to higher compensation, and reduced risk of company bankruptcy (Wiersema and Liebeskind 450).

Business research shows that the LBO is effective in reducing public company management's incentive to engage in unrelated and excessive diversification. LBOs cause changes in corporate governance structures that cause managers to reevaluate past diversification and search for assets that can be sold or shut down, causing efficiency gains (Phan and Hill 709 and Value-Based Management). The high degree of leverage leaves little free cash available for managers to excessively diversify, and managerial wealth depends more on firm value than on size and bankruptcy risk (Wiersema and Liebeskind 448). Management also has the incentive to reduce past unrelated diversification of the firm, including diversification before the LBO (Wiersema and Liebeskind 450 and Phan and Hill 709). After an LBO, there is a renewed emphasis on efficiency and a reduced emphasis on sales growth and market share, which leads to managerial reevaluation of the "empire building" of prior-period diversification (Phan and Hill 709). Also, managers may divest diversified assets to raise the capital necessary to service the debt (Phan and Hill 710). Though the evidence regarding LBO managers and diversification is complicated, the main point is that LBOs cause managers to diversify to the optimal level of efficiency and correct prior-period excessive diversification.

4.6.3 Managerial Incentives Regarding Changing the Organizational Structure

To achieve the optimal level of efficiency in a post-buyout company, managers have incentives to change organizational structure. Specifically, LBOs influence managers to increase decentralization and reduce hierarchical complexity. These organizational changes reduce pre-buyout organizational waste and inefficiency (Phan and Hill 711). They are the result of improved governance structures that reduce agency conflict and improve operating efficiency.

The first organizational change managers bring about after an LBO is decentralization. Decentralization has characteristics that bring about efficiency improvements (Phan and Hill 711). A decentralized company is one that allocates decision-making to individuals close to operations and the market. This makes decision making more effective, better utilizing resources and improving efficiency. Secondly, decentralization motivates low-level managers to improve their performance; greater responsibility increases job satisfaction (Phan and Hill 711). This greater effort on managers' part improves the company's efficiency. Furthermore, because decentralization tightens control in the company, individual departments and divisions can be controlled through monitoring of output (Phan and Hill 711). According to a study by Phan and Hill (1995), an LBO may increase decentralization for a couple of reasons. The need to make regular debt payments shifts management's focus to efficiency, and decentralization is one conspicuous means of achieving efficiency gains (Phan and Hill 712). Also, LBOs, especially going-private transactions, increase management stockholdings. Increased stockholdings gives managers an incentive to increase efficiency, which is often achieved through decentralization (Phan and Hill 712).

The second organizational change managers bring about after the buyout is a reduction in hierarchical complexity. The argument here, presented by Phan and Hill (1995) in the same

study, is similar to the argument regarding decentralization. Reduced hierarchical complexity may occur after an LBO because it enables efficiency, which will enable managers to make debt payments and improve the value of their increased stockholdings (Phan and Hill 714). Reduction in hierarchical complexity improves efficiency through removing organizational slack. Hierarchical complexity involves excessive personnel layers, creating a tall chain of command with confusing spans of control (Phan and Hill 713). Managers generally increase the size of departments they control, especially in expanding companies that need to solve problems created by growth (Phan and Hill 713-714). This hierarchical complexity can create a bureaucracy "resistant to change, lacking in accountability, slow to respond to market demands, and capable of deliberately or accidentally stifling communication" (Phan and Hill 713-714).

A less complex authority structure can improve efficiency in several ways. Shorter communication lines enhance the capacity, quality and speed of information flows and allow better and more comprehensive decision making (Phan and Hill 713-714). Additionally, greater flexibility in meeting market demands results. Finally, the removal of a significant number of middle managers would improve efficiency, provided effective operations are not removed (Phan and Hill 714). A relevant argument here is that if reduced hierarchical complexity, leading to efficiency, which is sought by LBO managers, results in middle managers losing their jobs, middle management would tend to fear such job losses after an LBO. The only certain conclusion, then, is that aside from middle management being removed, LBO managers would tend to favor reduced hierarchical complexity as a means of improving efficiency.

4.6.4 LBO Equity Structure and Agency Theory

Agency theory suggests that LBO managerial incentives include not only efficiency improvements to company structure but also consequences of the equity structure of LBOs. In

an LBO, managers can become owners of a significant portion of the post-buyout company's equity (Olsen and Gagliano 3). This is especially true in LBOs that involve buying a public company's outstanding shares to make it a private company. Such an LBO increases management stockholdings, reducing agency conflict by making management the company's shareholders (Phan and Hill 706). Specifically, in an MBO that involves management buying out its own company to take it private, managers own approximately thirty percent of the company's equity after the transaction (Baird 4). In such situations where post-buyout management owns a significant amount of equity, managers are expected to perform better because their personal wealth is at stake (Kaplan and Stein 315). Baird (1991) proposes that the potential for high managerial stock ownership in an LBO is a possible explanation for the existence and prevalence of the leveraged buyout. In an LBO, he suggests, new ownership of a mature company can better utilize assets by allocating ownership rights among management in a way that commits the company to use cash flow to pay off significant debt (Baird 8-9).

4.6.5 LBOs and Monitoring of Management

The last implication of agency theory for LBOs is the monitoring of management. In a post-buyout company, management is generally either more effectively monitored or has a reduced need of monitoring. In typical public companies, shareholder oversight of management is reduced by the vast number of shareholders, each with little wealth at stake (Wiersema and Liebeskind 448). This deficiency in corporate governance can be corrected by an LBO, which reduces the number of shareholders to a few very large stockholders whose wealth is greatly affected by managerial strategic decisions. These few shareholders monitor managerial actions closely and vigilantly (Wiersema and Liebeskind 448). Also, these shareholders are often private equity investors who become active members of the company's board of directors,

enabling them to monitor and control the post-buyout company's strategy (Nikoskelainen and Wright 512). Furthermore, LBOs that result in high managerial equity ownership result in managerial self-monitoring, due to management's wealth being at stake. Such significant stockholdings by management reduce the need for high monitoring of management (Nikoskelainen and Wright 512).

In summary, the implication of agency theory on LBO managerial behavior is an increased incentive for management to increase value to shareholders. Management is given the incentive to enhance efficiency through increasing firm value, engaging in related diversification, decentralizing, and reducing organizational complexity. Also, in MBOs and going-private LBOs, management's high stockholdings gives managers the incentive to perform better and reduces the need for monitoring. The smaller number of shareholders in a post-buyout firm improves monitoring of management. There is one counterargument to the use of agency theory to suggest increased efficiency through LBOs. This argument is that an LBO causes increased financial strain that causes management to seek out short-term efficiency and cut investments necessary for long-term efficiency. If this counterargument is true, the LBO would lead to decreased firm performance (Phan and Hill 714).

CHAPTER 5

MANAGEMENT OF LBO COMPANIES PURSUING EXIT STRATEGIES

Leveraged buyouts affect managerial behavior in many ways during the years following the acquisition. Additionally, there is the question of how the post-buyout company will be structured in the long-run. Gargiulo and Levine (1982) state that a major weakness of the LBO is the question of "how to get out of it downstream" (Gargiulo and Levine 18). In fact, many LBOs occur with the intention of the acquiring company making a profit and then somehow disposing of or restructuring the target company later on. The LBO fund usually attempts to realize a return within three to five years of the buyout (Olsen and Gagliano 4). This fact is consistent with studies showing significant value creation in the years following an LBO. One particular study showed that LBO companies doubled competitor profits (after tax, pre-interest) and outperformed their peers in stock and operating returns for at least four years following the leveraged buyout. This makes a buyout very attractive, since most initial public offerings (IPOs) underperform the market average for the first three years after the IPO (Jin and Wang). There are several possible exit strategies following an LBO, each with implications for managerial behavior.

There are three typical exit strategies following an LBO: an IPO, a sale to a strategic buyer, or recapitalization (Olsen and Gagliano 4). An IPO would allow investors in the LBO company to liquidate their ownership interest (Jin and Wang). An IPO would likely occur after an LBO that took a company private or after an MBO. If there is high managerial equity ownership after an LBO, especially in an MBO company, management may favor an IPO, allowing a cash-in within three to five years of the buyout (Michel and Shaked 170). The desire to cash in on managerial equity ownership may be the result of LBOs intending to profit from

arbitrage, which involves performing the buyout, restructuring the company, and then selling it back to the public markets after improving the value of the company (Halpern and Kieschnick 284). This is consistent with findings of a study of LBOs that made public companies into private companies; shareholders in the study gained an average premium of forty percent (Cumming and Siegel 441). During the period the company is highly leveraged, management with stockholdings can realize significant gains from increases in the value of company equity (Phan and Hill 710). Though management may have the incentive to favor an IPO within three to five years of the buyout, sometimes the company is either recapitalized or sold.

Recapitalization or sale of the LBO target may also provide gains to company management. Recapitalization, a large restructuring of the company's debt and equity structure, may allow managerial equity holders to take a sizable dividend. An outright or partial sale of the company to another strategic or financial buyer may also be an exit strategy (Jin and Wang). Strategic buyers usually are corporations, but may also include the employees through an employee stock ownership trust. In LBOs with little managerial stock interest, management may even be the buyer (Gargiulo and Levine 33). There is little empirical evidence with regard to managerial incentive to favor sale of the company as an LBO exit strategy. To the extent that management has stock ownership and can sell to the new buyer at a realized gain, management may tend to favor sale of the company. All the factors that existed in the target company before the LBO may once again be present for managerial consideration if the post-buyout company decides to sell its acquisition. In spite of the several possible exit strategies available for a post-buyout company, the investment can often be a permanent one (Gargiulo and Levine 33). In some cases, managers may be satisfied with their responsibility, compensation, and general benefits from working in a profitable post-buyout company. Indeed, such managers may prefer a

permanent, independent company. Other investors, however, may want to pursue an exit strategy (Gargiulo and Levine 33).

CHAPTER 6

CONCLUSION

Before, during and after a buyout there are significant changes in managerial behavior resulting from the buyout. Throughout the life of an LBO company, there is clearly a large responsibility placed on management. A briefing on LBOs from the American Management Association states that the buying company bets heavily on managers in a buyout (Gargiulo and Levine 30). Management is constrained to be "astute enough and psychologically able to handle the pressure from the risk of a lot of debt. A manager's life does not go on as usual with a heavy debt package." (Gargiulo and Levine 30-31) Additionally, "management must be…experienced in profit-center responsibility, asset management, and budgeting." (Gargiulo and Levine 30-31) Nonetheless, the question still remains: Is the effect of leveraged buyouts a change in managerial behavior that creates wealth for company stakeholders?

The answer is, "it depends". When viewing managerial actions of acquiring and target company management facing a possible LBO, one can note both wealth creation and stakeholder losses. Acquiring company management may favor the LBO because of the belief that it can better utilize the target's true capabilities. Specifically, MBOs allow management to buy undervalued companies and, because of high personal ownership, possess incentives to make improvements in market value and/or operating profits. Also, the MBO can be a defense against hostile takeover LBOs. Stakeholder losses include the threat of LBOs as hostile takeovers causing management to focus on short-term strategy. Alternatively, the modern fear of takeovers may cause restructurings that create large shareholder gains. Another detriment to company wealth is that target company management tends to fight an LBO because of the loss of job

security. Also, management in an MBO may attempt to underbid the fair market price of stock and manipulate earnings downward, to achieve this low price.

If one focuses, instead, on managerial actions following the LBO, there is much stronger evidence for wealth creation. The discipline of debt causes management to seek cash flows to make principal and interest payments. To meet cash flow requirements, management seeks efficiency improvements, including the sale of unprofitable divisions, the avoidance of low-return investments, the elimination of wasteful corporate expenses, the outsourcing of goods and materials, the reduction of employment growth rates, and the efficient growth of core and periphery businesses. Out of these efficiency improvements, the only notable stakeholder loss is that the reduction of employment growth rates results in termination of employees. In addition to an increased efficiency focus, LBO company managers focus on planning and monitoring activities to meet the debt discipline. These activities, which enhance economic vitality, include budgeting and forecasting, close evaluation of company performance, and the continuous monitoring of the possibility of financial distress. Creditors, as stakeholders, can benefit from management's careful handling of a syndicated debt load, with various levels of subordination and strict loan covenants to which the LBO companies are bound. To the extent that LBO companies become insolvent, creditors with a high degree of subordination suffer high losses, which may or may not be attributable to managerial actions. Agency theory implications suggest that LBO company managers have the incentive to reduce excessive capital expenditures, increase firm value, engage in related diversification, decentralize and reduce the hierarchical complexity of the organization, and protect the value of company equity. Managers pursuing an LBO exit strategy have a smaller effect on stakeholder wealth, though arbitrage efforts can have a dubious effect.

Assuming that LBO company managerial behavior does create stakeholder wealth, a relevant question is as follows: "Is the LBO implementable as a method to create wealth through changing managerial behavior?" Given that an LBO transaction has implications of wealth creation, it would seem that stakeholders of various U.S. companies would be heard clamoring for LBO acquisitions. This is not the case, though. In the current U.S. financial markets, there is no recognizable movement of company stakeholders advocating LBOs to change managerial incentives in their respective companies. The reason is the nature of the LBO; a high degree of leverage carries an inherently high financial risk. With a higher face value of outstanding debt, there is a greater probability of financial distress (Culp 48). Even if management of the post-buyout company is adequate, unforeseen events may disallow adequate payback of LBO debt. This fact makes the LBO unsuitable as a choice for assured wealth creation.

Another related issue is the significance of positive managerial behavioral changes in LBOs compared with such changes in other types of mergers and acquisitions. While the research being presented displays improved managerial actions in LBOs, the research does not list any similar managerial behavioral changes in corporate acquisitions with low leverage. For example, the LBO gives management the incentive to sell certain target divisions. While it is clear that this incentive is stronger in an LBO than in a less leveraged acquisition, the amount by which this incentive is stronger remains to be seen. A comparison of the degree of managerial incentive changes in LBOs to the degree of changes in other acquisition types is an interesting area for further study.

Leveraged buyouts do influence managerial behavior, and LBO company managers do create wealth for stakeholders. Buyouts also create inevitable losing situations. Bankruptcies occur. Employees are terminated. Potentially unethical hostile takeovers happen. Do these

losing situations outweigh the benefits of LBOs to the U.S. economy? Because the LBO is still a business topic under intense scrutiny, only time will tell. For now, the leveraged buyout continues to make company managers serious about wise use of assets to manage the “D” word: Debt.

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