Master's Thesis in Finance

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Results of buyouts in the 1980s and today

- A case study of the buyouts of Beatrice (1986) and HCA (2006) -

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Abstract

This thesis analyzes the leveraged buyouts of the 1980s and of today through three changes to corporate governance that Holmström and Kaplan (2001) saw as a result of an LBO: a resolution of the agency problem, the discipline of debt, and active ownership. By conducting case studies of the Beatrice buyout in 1986 and the HCA buyout in 2006, we will provide practical examples of these three issues, and try to find similarities and differences between the two LBO waves with regards to these three issues.

The findings show that the results of LBOs in fact are much the same today as twenty years ago. However, we find some differences: (1) The aim is to align managerial and shareholders' incentives, but this could be considered a more delicate issue today. Executive compensation has received much attention in the media, whereas a company that is taken private does not receive the same attention. (2) Debt levels are still high, but might have to be looked at more carefully today. The conglomerate structure in the early 1980s made it possible to a greater extent to sell non-core assets to pay down debt. (3) Active ownership is a key result of LBOs. However, we have reason to believe that consortiums of private equity firms will have a harder time deciding among themselves about the future of the portfolio companies, compared to if just one buyout firm purchased the company.

We also find that the way in which deals are done today is different as a result of the economic conditions of the respective time period.

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1. INTRODUCTION

1.1. Background

Mergers and acquisitions (M&A) have occurred in waves throughout the last century. The first American merger wave started around 1895 and was driven by an aim for a monopoly like position and is called the "merging for monopoly wave"[1]. The merger waves, which in general have lasted for around 10 years, all have individual characteristics and have been driven by different forces. The merger wave of the 1980s can be characterised by large hostile takeovers and leveraged buyouts (LBOs). The wave ended with the $30bn buyout of the food & tobacco conglomerate RJR Nabisco in 1989. In the following years, more firms began defaulting on their debt and the LBO activity decreased significantly.

Lipton (2006) argues that since 2002 we are currently in the sixth merger wave. In the sixth merger wave LBOs are again becoming a large part of the corporate restructuring activities. Renneboog and Simons (2005) calls this the second LBO wave. The second LBO wave has different characteristics from its predecessor. The deals are larger and the use of junk bonds to finance takeovers is smaller. In the last two year we have seen the largest deals ever. Excluding the buyout of RJR Nabisco the ten largest buyouts to date has occurred in the last two years[2]. During a time when deals are getting larger and larger the LBO sponsors, the private equity firms, are collaborating more than they've done before. A large proportion of the buyouts in the last couple of years have been carried out by consortiums of private equity funds. One reason for this is that the investment criteria of private equity funds often limit their commitment to an individual investment to around 10 % of their total fund. Therefore the private equity funds have to form consortiums with each other to meet the demand for acquisitions from their investors. For example, the recent buyout of hospital operator HCA was acquired by a consortium of private equity funds from Kohlberg Kravis & Roberts (KKR), Merrill Lynch and Bain Capital.

Private equity and buyouts in particular, is much less controversial today than in the 1980s and provides institutional investors with a satisfactory risk-return relation. As can be observed in

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[1] Black (2000)

[2] Financial Times, www.ft.com/cms/s/34b38b92-270a-11db-80ba-0000779e2340.html

Figure 1.1.1. the private equity firms are raising billion dollar funds and can't find enough investment opportunities.

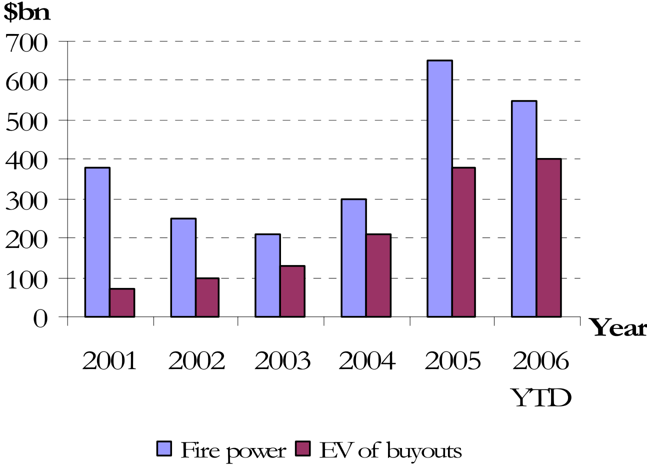

Figure 1.1.1. LBO funds fire power vs. actual investments[3]

Increased acceptance of LBOs, a huge supply of money, an attractive debt capital market with low interest rates as well as banks competing to finance LBOs provides the private equity funds with an enormous buying power. However, it is not certain whether we are experiencing a temporary attractive environment for LBOs or if the general view on the phenomenon has permanently changed.

1.2. Purpose

The purpose of this thesis is to analyse and compare the wave of LBOs that occurred in the 1980s with the wave that we are currently seeing. Our aim is not to provide extensive insight into the LBO as such, but rather focus on a few key results of an LBO that were highlighted by Holmström and Kaplan (2001). They found that LBOs were associated with three large changes in corporate governance:

1. "LBOs changed the incentives of managers by providing them with substantial equity stakes in the buyout company"
2. "The high amount of debt incurred in the leveraged buyout transaction imposed strong financial discipline on company management."
3. "Leveraged buyout sponsors or investors closely monitored and governed the companies they purchased"

[3] Dealogic: Private Equity Intelligence, assuming D/E levels of 5x

Within each topic, we will incorporate theories that relate to these issues. Then, to gain a more practical understanding we will conduct case studies of the buyouts of Beatrice (1986) and HCA (2006) to try to understand if there are any general differences between LBOs in the 1980s and today with respect to the three changes listed above.

1.3. Outline of the thesis

We will structure our thesis in the following way; section 2 will consist of a theoretical background of merger waves and an introduction to LBOs. Section 3 and 4 will consist of the two case studies, the 1986 buyout of Beatrice, and the 2006 buyout of HCA, which will bring a practical perspective to the issues we have focused on. We will follow up in section 5 and 6 with an analysis and a conclusion of the findings.

2. THEORETICAL BACKGROUND

This section will cover relevant theories that are of interest for this thesis, such as the concept of merger waves, the structure of an LBO and the theories that will be applied in the case study.

2.1. Merger waves

Following the Civil War in the US, American companies acted in a highly regulated environment regarding mergers. The capital requirements needed to buy another company were severely limiting merger activities. Corporations were not allowed to own stock in other companies, their financing activities were tightly regulated and mergers were often illicit. In the 1880s New Jersey loosened the restrictions on merger activity and during the same time the New York Stock Exchange emerged as an effective market for stocks. The Sherman Antitrust Act ruled out collusive agreements between firms, but allowed the creation (through mergers) of firms with up to 90 % market share.[4] These institutional changes were catalysts for the first merger wave known as "merger for monopoly".[5] In the first merger wave about 75% of all mergers involved companies within the same industry. About 40% of all US companies were involved in some kind of transaction. Primarily the largest companies in each industry merged in order to enjoy the benefits of a monopoly like position. The wave ended with the stock market crash of 1904 and the Bank Panic in 1907.

The second merger wave occurred during the 1920s and coincided with a booming stock market, which was susceptible to issuance of new securities for finance takeovers. The wave saw further consolidation in the industries that were subject to the first merger wave – basic manufacturing and transport industries. However, due to regulation firms were unable to form monopolies but oligopolies were still permitted. This wave is characterised by vertical integration. For example, Ford integrated from the finished car back to steel mills, railroads for transport etc[6]. The wave ended with the great depression and the crash of 1929.

The third merger occurred during the 1960s and 1970s and like the previous waves it occurred during a stock market boom. This enabled buyers that were paying with their own stock to acquire at attractive cost. The third wave was characterized by an extensive creation of

[4] Shleifer and Vishny (1991)

[5] Stigler (1950)

[6] Lipton (2006)

conglomerates. Following the Celler-Kefauver Act (also known as the Anti-Merger Act) firms in the same industry were prohibited from merging. A favourable market for equity issues led firms with cash to acquire firms in completely unrelated industries, leading to the creation of major conglomerates. The creation of conglomerates had several rationales. First, conglomerates reduce risk through diversification. Second, it was believed that management skills were easily transferable between industries. Third, the creation of an "internal capital market" where cash generating divisions would provide cash to fast-growing divisions that needed funds. Shleifer and Vishny (1991) argue that it is likely that CEOs wanted to grow their companies and had to look outside their industries for growth, due to the regulatory environment. The authors' reasoning indicates that shareholders would have been better served if companies had paid out their huge profits in the 1960s instead of growing through diversification.

As with the past merger waves, the 1980s saw increased stock prices and corporate reserves stimulating the demand for growth through acquisition. In addition to this the American government led by Ronald Reagan relaxed the restrictions on intra-industry merger activity in an attempt to leave the market alone.[7] As a result of this change in regulation firms could now merge and acquire other firms within their industry for the first time in over 30 years. This led to the merger wave which covered the 1980s. The merger wave was characterized by a higher level of hostile takeovers, the dawn of junk bonds (high-yield bonds with high default probability) and LBOs.

A large amount of the takeover targets were conglomerate firms in which the buyers looked to divest unrelated divisions under the assumptions that the divisions were more valuable as stand alone units than as part of a conglomerate. Some of the takeovers included the bidder not intending to retain anything of the target firm. Typically these kinds of deals were done by the 'corporate raiders' and by LBO funds. Shleifer and Vishny (1991) shows that during the period 1984-1986 on an average the LBO takeovers sold off 40 % of the assets and realised significant profits. The management of the firms also realised that they could benefit from the organisational inefficiency and often the management conducted their own leveraged buyout, a management buyout (MBO). This led to a sharp increase in the number of public-to-private transactions during the merger wave, which is depicted in Figure 2.1.1.

[7] Shleifer and Vishny (1991)

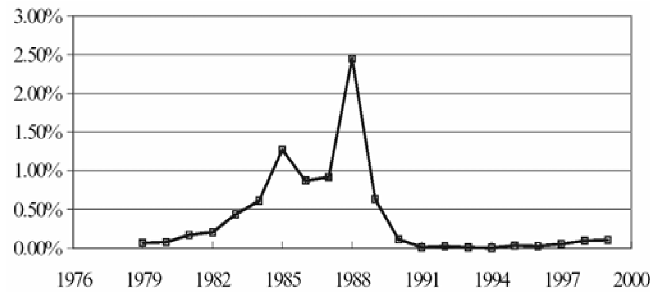

Figure 2.1.1. Going Private Volume (% of total US stock market value)[8]

Even though the LBO as a phenomenon was present before the 1980s wave it is considered that the merger wave symbolizes the birth of the LBO. Hence, the merger wave can therefore be called the first LBO wave. The wave survived the stock market crash in October 1987, but ended with the buyout of RJR Nabisco in 1989 along with the collapse of the junk bond market.

The fifth merger wave started in the mid-1990s and was very different from the previous wave. Andrade et al (2001) argues that industry shocks and increased industry deregulation (e.g. banks, utilities and telecom) were major drivers of M&A activity in the 1990s. Industries react to shocks, such as deregulation or technological change, by restructuring and mergers is a common way to achieve that. A significant difference from the 1980s was that buyers now used stock as the number one method of payment. As a result, the hostility decreased significantly and the number of LBOs was extremely low. Holmström and Kaplan (2001) point out that power shifted from corporate stakeholders to shareholders due to the rise in the number of institutional shareholders. This made companies pursue more shareholder friendly policies and can be thought of as one explanation for the decrease in hostile takeovers in the 1990s since there was no need for hostility anymore to make the companies become more shareholder focused. Hence, most of the mergers were "mergers of equals" and the activity increased considerably during the 1990s. The total deal value increased from $342 billion in 1992 to $3.3 trillion in 2000. However, as was observed in Figure 2.1.1. the LBO activity was very low. The merger wave ended with the downturn in the IT and technology sector. Compared to the 1980s, the junk bond market was almost nonexistent, banks had tightened their lending standards and the equity market did no longer favour merger announcements.[9]

[8] Holmström and Kaplan (2001)

[9] Lipton (2006)

Since 2002 the merger activity has again increased until today which indicates a sixth merger wave. Lipton (2006) argues that globalization and encouragement by governments of some countries, the availability of low-interest financing and the extreme growth of private equity funds have produced the sixth merger wave. He claims that a major driver of the wave is the pressure on companies from active hedge funds and activist institutional investors. These actors are pressuring the companies to act, such as putting up the company, or divisions, for sale if the circumstances are the right ones. The level of hostility has increased compared the 1990s, indicating that hostile takeovers are being accepted again, as a mean to achieve considerable changes in companies. The fact that the LBO funds are gathering significant amounts of money in their mega-funds creates a huge demand for investment opportunities. In addition, a new phenomenon for the sixth wave is the *club deal*. A *club deal* occurs when as many as five or six LBO funds acquire together. This has enabled the LBO funds to do mega-deals such as the HCA and Kinder Morgan deals. Four of the five largest LBOs of all times have been carried out in the second part of 2006 indicating a second LBO wave.

2.1.1. Reasons for merger waves

There have been several attempts to try explaining why merger waves occur. The competing explanations can be categorized into two groups. The neoclassical theories states that industry shocks (e.g. technological, regulatory or economical) leads to industry reorganization and merger waves. The behavioural theory states that overvaluation in the aggregate or in certain industries would lead to wave-like clustering in time. This implies that managers of overvalued firms would merge and/or acquire fairly priced firms paying with their overvalued equity which would trigger merger waves.

Mitchell and Mulherin (1996) emphasize the first approach – that industry shocks trigger merger waves. It can be observed in the historical merger waves that shocks that enable alterations in industry structure such as deregulation, changes in input costs, and innovation in financing technology have created significant merger activity. The authors claim that tender offers, mergers, and LBOs are the least costly and most efficient means for industry structure to respond to changes caused by economic shocks.

Harford (2005) test the conclusion of Mitchell and Mulherin and compare it to the behavioural hypothesis of misvaluation. Harford does not find support for the hypothesis that misvaluation can result in merger waves. Instead he finds support that economic, regulatory and technological shocks drive industry merger waves. However, he also finds that shocks are not sufficient to

generate a merger wave. In fact, not all shocks will propagate a wave since sufficient capital liquidity must be present to finance the necessary transactions. He concludes that

"The reduction in financial constraints that is correlated with high asset values must be present for the shock to propagate a wave".[10]

In the case of the merger wave in the 1980s and 2000s (first and second LBO wave) the first exhibited capital liquidity as a result of the rise of the junk bond market while the second wave is characterized by huge amounts of cash in the LBO funds. These empirical finding clearly support Harford's result.

Kaplan and Stein (1993) find that the capital liquidity of the merger wave of the 1980s had a critical role in the sudden death of the wave. They discuss the concept of an overheated buyout market where the junk bond market led to uneconomic transactions in the late stage of the wave, when the junk bond market grew in attractiveness. This pushed up the prices in those late deals where junk bonds were a significant part of the financing. This increased the risk of the transaction which led other less aggressive lenders (e.g. banks) to react defensively by reducing their commitment in those transactions and demanding faster debt repayment to ensure their seniority. On the other side, the junk bond investors accepted this. Hence, their risk further increased and accelerated the process.

Another factor that significantly improves the chances of a merger wave is over-optimism in the market. In an overheated market, investors expect high level of return and growth, generating merger transactions. In a bull market Lipton (2006) argues that investors tend to disregard the supposed high rate of merger failure, which would further strengthen the theory that over-optimism has a positive effect on the creation of a merger wave.

Thus, the neoclassical explanation for merger waves is intuitive: merger waves require both an economic motivation for transactions and relatively low transaction costs to generate a large volume of transactions.

[10] Harford (2005)

2.2. Overview of leveraged buyouts

A leveraged buy-out (LBO) is often referred to as a financing technique for acquiring a company. Generally in LBOs, a large amount of the purchase price is borrowed, the company goes from publicly owned to privately owned by investors in a private equity fund and generally also senior management of the company.

Not all companies are suitable to be taken private through an LBO. Desirable LBO candidates are according to Jensen (1988) firms or divisions of larger firms that have *"stable business histories, low growth prospects and high potential for generating cash flows".* This is also generally the view of private equity firms when evaluating prospects. It is in these firms that the agency costs of free cash flow are most likely to be high.

In the 1950s and 1960s smaller companies were bought with large amounts of debt but it was not until the 1970s and early 1980s that LBOs grew in popularity. Investors such as pension funds invested money into private equity funds, providing the equity financing. In addition, the private equity people themselves invested money, and so did the management of the company. One success-factor was that management had a significant sum at stake in the company, either as a private investment or as stock options, which worked as an incentive for managers to run the company well. The debt was provided by banks and other lending institutions, but also investors in high-yield, or below investment grade, debt. The increase in the junk-bond market in the 1980s provided the private equity funds with substantial leverage opportunities.

In 1986, the then-largest LBO in history was the buyout of Beatrice, which we will focus on in a case study, an international consumer and industrial products firm, for $8.2 billion. The capital structure of that LBO could be seen as a typical capital structure for an LBO in the 1980s (Baker 1992) where 84% was debt.

The aim of the private equity funds is to generate returns on their investors' money by buying and selling companies like Beatrice. By only providing a small amount of the purchase price through equity financing the return on the equity investment can become much higher than the overall return from selling the company since debt comes with a fixed interest expense.

2.3. What value does LBO's add?

Kaplan (1989) supports the theory that taxes are a large source of gains in buyouts but there are more gains to be taken into account. According to Jensen (1988), LBO firms created wealth and had a competitive advantage over other corporations because of the ability to control the agency costs of debt, which will be discussed below. Opler and Titman (1993) compared the characteristics of firms that implemented LBOs in the 1980s with the ones that did not, and found, like Jensen, that *"free cash flow problems and financial distress costs are important determinants of which firms undertake LBOs"*. Kaplan and Holmström (2001) support evidence that LBOs improves efficiency in companies. They find that one of the main benefits of LBO associations was that they did not permit cross-subsidization. What corporations often did during the conglomerate era and later was to support poor performing divisions using cash from more successful ones, instead of returning it to shareholders. LBO organizations were better at controlling this.

To find empirical evidence of the benefits of high leverage, Denis (1995) compared the leveraged recapitalization of Kroger and the LBO of Safeway. This was interesting because the leverage levels in the two companies after the recapitalization and the LBO were the same, a debt-to-value level exceeding 90%. Denis found that Safeway tied managerial compensation closer to firm performance, while no such changes were made at Kroger. Safeway also serviced their debt by selling assets while only making minor reductions in capital expenditures, while Kroger cut back on capital expenditures and sold fewer assets. Safeway earned greater stock returns following their buyout than Kroger did after their recapitalization. Denis also found that although the recapitalization did not improve operating performance and value as much as Safeway, it still did very well. Denis mean that you do not necessarily need a new organizational form (the LBO) in order to achieve the value enhancements related to a highly leveraged capital structure, but you will not reach full potential without the incentives of managerial equity ownership or the monitoring of large shareholders.

It can be questioned whether it is necessary to restructure a company through an LBO to achieve the advantages discussed above. LBO critics suggest that the same result can be achieved by undertaking a corporate restructuring and, hence, that LBOs are unnecessary. Thomson and Wright (1995) argue that young firms and firms close to bankruptcy are the ones run most efficiently. For young firms, this is because there is still a major ownership interest of the founders, venture capital investors are highly active and banks and other debt holders perform important monitoring. In the case of firms close to bankruptcy, the debt (and equity) holders

reassert control over management. Thomson and Wright argue the restructurings such as LBOs and MBOs provide the best tools to restore active governance and create the characteristics of a newly emerged and/or bankruptcy firm by re-concentrating equity and creating the important monitoring.

Financially, from the new owners' perspective, most buyouts have been great successes. But the results of LBOs have been discussed widely, often controversially. Susan C. Faludi won the Pulitzer Prize for an article on the Safeway LBO, which KKR conducted in 1986[11]. The article focused on the human costs of the buyout including substantial employee layoffs and shutdowns. On the financial side however, the buyout was a success. As in the case of Safeway, through financial and operational efficiencies and structural changes such as sales of non-core assets or divisions, the firms that were taken private could be sold or taken public again at a substantial profit to investors.

2.3.1. Managerial incentives & the agency problem

In traditional companies owners hire a professional management to run the firm. This gives rise to problems related to the separation of ownership and control, so called *agency problems.*[12] Jensen and Meckling (1976) define an agency relationship as "*a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf*". This delegation of responsibility also involves the delegation of authority to the agent. The principal demands that the agent acts in his/her best interest. However, under the classical assumption that everyone is a utility maximizer, the agent will probably not always act in the best interest of the principal. In applying the agency theory on a firm, one can clearly see the problematic of owners (principal) trying to get managers (agent) to act in their interest. Examples of non-efficient behaviour of managers can be extensive use of corporate perks or undertaking of projects with a negative net present value (NPV). However, one of the main advantages of LBOs is that they realign the incentives of the managers with the ones of the owners, so that managers act more in line with the objectives of shareholders.

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[11] The Reckoning: Safeway LBO Yields Vast Profits but Exacts A Heavy Human Toll --- The '80s-Style Buy-Out Left Some Employees Jobless, Stress-Ridden, Distraught --- Owner KKR Hails Efficiency , 16 May 1990, The Wall Street Journal

[12] Jensen and Meckling (1976)

As have been pointed out by Holmström and Kaplan (2001) the ownership in LBOs is constructed in a way so that agency problems are minimized. They argue that management generally increases their equity stake to 6.4% post-LBO. However, it is not only the percentage of equity that aligns the incentives. Jensen (1997) finds that LBO organisations not only have higher upper bounds than do "traditional" companies, but they tie bonuses much more closely to cash flows and debt retirement than to accounting earnings. He also finds that the total compensation of managers of LBO firms, including salary, bonus, stock options etc, is around 20 times more sensitive to firm performance than that of the typical company manager.[13] By using the LBO incentive realignment the managers will serve the best interest of the shareholders and, at the same time, maximize their own utility.

Opler and Titman (1993) find that the gains from the incentive realignment are related to the extent to which the LBO target is diversified. During the 1980s a lot of the LBO targets were conglomerates. The rationale for this is that diversified firms may cross-subsidize poorly performing division with cash flows from stronger divisions. The authors argue that the realignment of managers' incentives has significantly improved shareholder value by making the targets more efficiently run. This often includes selling off assets (divisions) that are not profitable, and hence becoming more focused after an LBO. In fact, it is common for LBO sponsors to commit to sell off unprofitable assets as a part of their bank debt covenant.

2.3.2. Discipline of debt

LBO firms are highly levered. One of the most evident reasons for this particular capital structure is to take advantage of the tax deductibility of interest on debt and eliminate taxable income and, hence, taxes paid. But firms generally take on more debt than that, so we cannot believe that they do it for tax reasons only (Opler and Titman 1993). Another reason is that debt enables managers to contractually bond their promise to pay out future cash flows, in order to repay debt obligations. Thus, LBO firms, through the heavy debt load, put tighter restrictions on management in order for them to repay the debt. This is the disciplinary role of debt. Higher debt levels reduce the agency costs of free cash flow by reducing the cash flow that managers could spend at their own discretion. The threat of not being able to pay interest, and thus go into financial distress or bankruptcy serves as an incentive to spend cash more efficiently. The control function of debt is most important in companies with low growth prospects that are highly cash

[13] Jensen (1997)

flow generative. In these cases the opportunities for management to divert cash is high. It is also in these companies that the impact of an LBO is most important (Jensen, 1988).

The heavy use of debt in LBOs comes with risks – financial distress and bankruptcy costs. Asquith et al (1994) researched junk-bond issuers and found that firms became financially distressed either through high interest expense, poor operating performance or an industry downturn. They found that there are relatively few firms that are in financial distress for purely financial reasons. Issuers actually suffer from economic distress both at the firm level and at industry level, i.e. the operating performance of the company is what most often causes the distress, not the interest expense. Economists have generally found it hard to measure the costs of financial distress, since it is hard to distinguish whether distress is caused by high leverage or operational shocks. Andrade and Kaplan (1998) try to mitigate this problem by only having firms with positive operating margins in their sample. They estimate the costs of financial distress to be 10 to 20 percent of firm value.

When firms go into financial distress and are unable to repay their debt, they try to go through a period of restructuring and potentially change the conditions of the contracts. Restructurings could include reduced interest rates, delays of principal and interest, or increased collateral. In addition to restructurings, banks also sometimes provide additional financing. Bank debt is usually restructured through negotiations. Public debt, on the other hand, is restructured through an exchange offer where cash and securities are offered in exchange for debt (Asquith et al, 1994). An alternative to debt restructurings is asset restructurings, which could include an improvement in existing operations, a sale of assets, or a reduction in expenditures (Asquith et al, 1994). While debt restructuring is a means to reduce cash outflows, asset restructuring is a means to increase cash inflows. Asset restructurings was widely used in the 1980s when companies that had been taken private in LBOs used asset sales as a source of cash to repay debt, and as a way to get a more focused organization.

Asquith et al (1994) show how debt structure affects the probability of bankruptcy. They find that while the *level* of debt is what generally is focused on, the *composition* of debt – the fraction of debt that is public, the number of public debt issues, and the fraction of private debt that is secured – is important for how firms react to financial distress. An increasing number of issues outstanding will bring higher bargaining costs, which can get in the way of out-of-court

restructurings. Secured creditors have higher incentives to trigger bankruptcy, and the authors find that bankruptcy occurs more often when a larger amount of the private debt is secured.

2.3.3. Active ownership

In an LBO the buyer acquires a majority stake (often 100%) in the acquired firm. It is often the case that LBO targets have dispersed ownership with a lot of small owners. A firm with a large number of small, and often passive, owners will experience significant cost and problems with monitoring management and instructing them on how to manage the company. Concentrated ownership, brought as a result of an LBO, has the potential to reduce potential free-rider problems since the incentive and resources to monitor managers are greater for holders of large blocks of equity. Jensen (1989) claims that, since the LBO sponsor often has close to 100 % ownership, the board of directors becomes an arena where the sponsor's decisions are only formally taken. The decisions are already taken at the owner (LBO sponsor) level. Hence the communication between owner and manager becomes much more direct. This fact, in combination with a stronger owner and the realigned incentives for managers, calls for improvements in both productivity and efficiency.

At the same time as being active owners, LBO sponsors are more decentralized than publicly held conglomerates (which they acquire to improve).[14] Even though the LBO structure calls for a strong and active ownership the mere system of an LBO is supposed to drive the development of the firm. LBO sponsors, such as KKR, own a significant number of large companies and are not constantly supervising these portfolio companies.

[14] Jensen (1989)

3. CASE STUDY OF BEATRICE

This case study follows the 1985-86 $8.2 billion buyout of Beatrice by KKR. We will base the information in this case study on the Journal of Finance article "Beatrice: A Study in the Creation and Destruction of Value" by George P. Baker. This is followed by an examination of the three factors that are viewed by Holmström and Kaplan (2001) as the key effects following a buyout: mitigating the agency problem; the discipline of debt; and the close governance of the buyout companies by the LBO firms.

This particular buyout gives clear examples of how asset sales can be used to repay debt and create value for shareholders. At the time of the buyout, Beatrice also had what could be viewed upon as a conglomerate structure. After the buyout the management was changed, but the new management had relations to Beatrice from before. Former managers of Esmark, one of Beatrice's largest acquisitions, became the new management team. This buyout was the largest of its kind when it was announced.

3.1. Economic condition in the 1980s

The economic and political conditions of the 1980s forced corporations to restructure in order to take advantage of opportunities and to eventually be efficient (Jensen 1988). The conditions Jensen names that contributed to high takeover activity were *"the relaxation of restrictions on mergers imposed by the antitrust laws, withdrawal of resources from industries that are growing more slowly or that must shrink, deregulation in the financial services, oil and gas, transportation, and broadcasting markets, and improvements in takeover technology, including a larger supply of increasingly sophisticated legal and financial advisers, and improvements in financing technology such as the strip financing commonly used in leveraged buyouts and the original issuance of high-yield non-investment-grade bonds."*

The establishment of a "junk bond market" was a major factor contributing to increasing takeover and LBO activity in the 1980s. These bonds were rated below investment grade by the rating agencies because of their high probability of default. High-yield bonds were first used in a takeover bid in 1984, and when early deals went well, investors grew more and more hungry for these bonds, and suddenly debt financing for deals were relatively easy to get hold of.

The relaxation of the antitrust laws in the 1980s by the U.S. President Ronald Reagan resulted in mergers within industries becoming possible to a much greater extent. This was a big factor that

helped produce the wave of takeovers in the 1980s. Many companies still had the conglomerate structure from the 1960s, when takeovers within industries were not allowed for larger firms (Shleifer and Vishny, 1991), and wanted to focus on their core business and grow. When regulatory rules on antitrust were loosened, companies started divesting non-core assets and acquiring companies within their own industries. This also created opportunities for financial buyers, private equity firms, to buy divisions of companies. It also created opportunities for private equity firms to buy firms with a conglomerate structure. If the parts of the company would be worth more than the whole, they could create value by selling the assets in smaller pieces. Or, they could sell a few divisions to help repay debt and repay the equity investment and still be left with a company that had significant value that could later be sold generating high returns on the original investment.

Many theorists argue that before the 1980s, managers were loyal to the corporation, not to the shareholder (Holmström and Kaplan 2001). External governance mechanisms that were available to shareholders were rarely used, board oversight was weak and managerial incentives from ownership of company stock were small. Performance plans were based on accounting measures that tied performance less to shareholder value. When the shareholder and stock prices came more into focus, an increased pressure was placed on managers to be more efficient and not waste cash.

These were the thoughts of the times when the LBO market grew in popularity in the 1980s. By that time, investing in private equity funds were at its infancy. As this became more and more popular, the funds became larger and prospective targets thus grew larger and larger. Prior to KKR's Beatrice buyout, KKR had put together four funds. The first in 1978 was $32 million while the fourth in 1984 was $1 billion (Kaufman and Englander, 1993).

3.2. Events leading up to the buyout

Beatrice was founded in the late 19th century and was originally a company active in the dairy business. It acquired a number of dairy companies and eventually started diversifying into foods in the 1940s and in the following decades. The market reacted favourably to the regional expansions in the dairy industry and to the diversification into the food business.

The move into a more conglomerate structure came in the 1960s, when the Federal Trade Commission (FTC) in the US in 1965 decided that Beatrice would have to divest plants amounting to $27 million in sales and to refrain from further acquisitions in the dairy industries.

This decision by the FTC made Beatrice go more and more into a conglomerate structure. This decision was an example on how the merger and antitrust laws at the time could affect companies.

In the early 1980s, with a new CEO, Beatrice went through a range of diversified acquisitions and other strategic and organizational changes, which the market did not react favourably to. The board of directors eventually forced the CEO to resign in August 1985. During his tenure, many other executives had left the company. Baker (1992) argues that Beatrice lost a significant amount in market value during the late 1970s and early 1980s, and the market reacted negatively to the further acquisitions that were made. He poses two explanations to the loss in value and the loss in confidence by investors. There were scepticism towards management and their ability, and a concern that the board of directors could not handle the problem.

Donaldson Lufkin and Jenrette mentioned in an analyst report in August 1985 (Leach, 1985) that the removal of the CEO was positive. They also mentioned that the "parts seem to be worth more than the whole". However, they also mentioned that "it is unlikely that the company actually will be broken up".

3.3. The Buyout

In October 1985, KKR made a bid for Beatrice. The price they paid was eventually 53% above market value. They brought in four executives from a company Beatrice recently had acquired. These four sat on the board alongside six representatives from KKR. The new CEO, Don Kelly, invested $5.2 million in the company by purchasing 1% of the shares and options on another 6.5%. Other top management bought 5.5% of the post-buyout stock (Anders 1992). From Table 3.3.1. below, we can see that the capital structure contained 84% debt.

Capital Structure of the Beatrice LBO, with Equity Ownership			
	$ Millions	% of Total Liabilities	% of Fully Diluted Equity
Debt			
Bank Debt	3,300		
Subordinated Debt	2,500		
Assumed Debt	1,050		
Total Debt	6,850	84.1	
Redeemable Preferred Stock			
Total Preferred	880	10.8	
Common Stock			
KKR Stock	400		57.5
Management Stock	7		1.0
Management Options	0		11.5
Warrants	10		30.0
Total Common	417	5.1	100.0
Total Funding	8,147	100.0	

KKR estimated that $1.5 billion of asset sales would be required to meet the first two interest payments in nine and eighteen months. After that, cash flow from operations would be sufficient. The newly taken private Beatrice started selling assets at great speed, both to trade buyers and to divisional managers who took over through LBOs (Baker, 1992). Baker (1992) investigates the assets sold and finds that they most often sold to the same type of buyers, private or public depending on how they had been owned when Beatrice originally acquired them. There were apparently more efficient ways of running these companies than as part of a big conglomerate. The value that the assets could be sold for was high and eventually, after significant asset sales which resulted in the bank debt being almost fully repaid in the first year, KKR sold what was left of Beatrice in 1990. It resulted in an annual compounded return on the equity investment of 83% (Baker 1992).

3.4. Managerial incentives & the agency problem

Prior to the buyout and before the significant organizational changes at the end of the 1970s, Beatrice had a highly decentralized organizational structure. Each division ran their business rather independently and had its own CEO. They also had incentive systems in place where managers received a percentage of profits, and since 1957, certain managers also had received stock options, a plan that eventually expanded to include all plant managers. Internal promotion systems for management positions had been in place, which worked as an incentive. On the new management's request, Beatrice started centralizing its structure in the late 1970s. That troubles were going on inside the organization was strengthened by the fact that many executives left the company (Baker 1992). They were not allowed to operate as independently as they did before.

When James Dutt became CEO in 1979, he started focusing on marketing. He moved corporate headquarters and started spending millions on sponsoring racing teams, when racing was one of his interests. The marketing was focused on Beatrice as a company, not the individual brands, which was the way things usually were marketed in the food business. This was not the way in which it had been done at Beatrice before. The market did not think that Dutt was running the business in the best interest of the shareholders and the stock price reacted negatively. On the other hand, these things could be viewed as indications that he was running the company in interests that were closer to his own rather than the shareholders.

After the buyout, the new executives were allowed to purchase post-buyout stock. Their incentives were therefore in line with the new owners, to maximize shareholder value. In order to do this, they first had to go through $1.5 billion of asset sales in order to meet the first two interest payments. After that, while the company could have serviced the debt load through operating cash flow only, they sold more assets. They also decreased costs in places such as advertising. They must have realized that it was better to sell the companies then to run them. In this case we believe that keeping the firm as a going concern was not a main objective. One could speculate that if the CEO had not owned any stock of his own, he would have been more inclined to keep the company running for years to come and for the company to be large, because of the satisfaction he would get from being the CEO of a large company. We thus believe that he would not have been as keen on selling parts of the business if he had not been a significant shareholder. Now, he was mainly interested in the returns on his investments, which made it easier for him to execute certain actions.

We believe that in this case, as well as other cases involving a company having gone through an LBO, managerial ownership is a key issue in generating returns to shareholders. If the incentives of management and the owners were in line, managers would not want to waste money on insignificant things since in part it was their own money that they were spending. Returns to shareholders would be the main objective and things such as prestige from a CEO position would be nonexistent. This would generally be the case for companies having gone through an LBO. We think that in listed or family owned companies, the aim might be different. Here, one may think that the main goal would be to keep the company profitable for a long period of time.

3.5. Discipline of debt

As we observed in Table 3.3.1. the LBO, as is common, was structured with significant amounts of debt. We can suspect that because of the large amounts spent on advertising and sponsorship before the buyout, that Beatrice generated positive excess cash flow. This is also confirmed in the DLJ research report (Leach 1985). Like Opler and Titman (1993) thought in general, we believe that the reason for levering Beatrice was more than just because of the tax benefits. But we do not think that in this case, the management needed to have tighter restrictions. In this case, management thoughts of what was needed were in line with the owners. The disciplinary role of debt was in this case only strong when it came to meeting the first two interest payments, when assets had to be sold. After that, all focus seems to have been on generating returns on the investments. Since almost all bank debt was repaid within the first year, and the asset sales kept going on, repaying debt was never a problem.

Asquith et al (1994) mentioned that debt restructurings and asset restructurings were common ways to go about when firms were unable to repay their debt. In the Beatrice case, we can see that the company went through an asset restructuring right away, without going into financial distress. If they had not done this, they would of course have gotten into financial distress. This was good because as an LBO firm that is dependent on having institutions lend money for buyouts, a clean track-record and a reputation of always repaying the debt is crucial. For KKR, getting into financial distress was not an option. Regarding Asquith et al's theory about the composition of debt, that secured creditors have higher probability of triggering bankruptcy, this case may give strength to the theory since KKR chose to repay the bank debt first.

3.6. Active ownership

In the case of Beatrice we can discuss active ownership in many ways because in their buyouts, KKR appointed managers to lead the companies. This was probably the best way to go about given the size of KKR's portfolio of companies; they could not run the companies by themselves, and nor was it an intention either. In the case of Beatrice, they appointed Donald Kelly, who specifically wished to run the company without much interference from KKR (Anders 1992). So in this case, the active ownership came from appointing the right management, and making sure that management's incentives were aligned with their own. But as owners, could KKR then be considered as active? KKR controlled the company, had the most seats on the board and was by far the largest shareholder. Comparing with a regular sized listed company the ownership structure would have been much more dispersed, and managers would have more

freedom to do what they wanted and get away with it and they would not be monitored in the same way. With regards to active ownership in the case of Beatrice, KKR would be considered as an active owner.

4. CASE STUDY OF HCA

HCA Inc. is a holding company whose affiliates own and operate hospitals and related health care entities. The term "affiliates" includes direct and indirect subsidiaries of HCA Inc. and partnerships and joint ventures in which such subsidiaries are partners. At September 30, 2006, these affiliates owned and operated 172 hospitals, 95 freestanding surgery centres and facilities which provided extensive outpatient and supplementary services. Affiliates of HCA Inc. are also partners in joint ventures that own and operate seven hospitals and nine freestanding surgery centres which are accounted for using the equity method. The Company's facilities are located in 21 states in the USA, England and Switzerland.[15]

4.1. Economic condition in the 2000s

Following the dramatic buyout market in the 1980s, the LBOs were rarely observed during the early 1990s. During the late 1990s they started to appear again. However, as discussed earlier, they were now characterized by a low level of hostility. The view on LBOs had slowly changed and the phenomenon was more accepted. As can be observed in figure 4.1.1., the funds raised in Europe increased significantly from €8 billion in 1996 to around €50 billion in 2000. However, the buyout activity of the 1990s never reached the extreme levels of the 1980s.

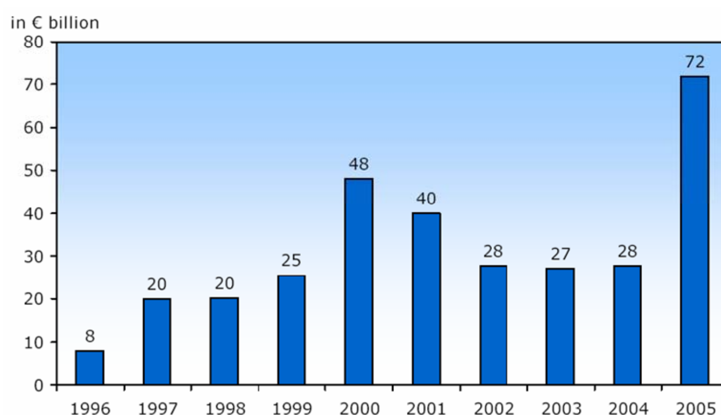

Figure 4.1.1. Private equity fund raising[16]

The buyout activity in Europe, US and the rest of the world was hugely affected by the crash in the IT and hi-tech sector during 2000 and the fund raising and investments decreased. It reached

[15] http://www.sec.gov/Archives/edgar/data/860730/000095014406009715/g03800exv99w1.htm

[16] http://www.evca.com/images/attachments/tmpl_21_art_32_att_980.pdf

its peak in 2000, after which the private equity investments and funds raised fell in the next couple of years due to the slowdown in the global economy and declines in equity markets, particularly in the technology sectors. The fall in funds raised from 2001 to 2004 was also due to a large excess created by the end of 2000 of funds raised over funds invested. As the overall economical situation improved following the crash with beneficial interest rate levels for LBOs, the buyout funds found investments and starting raising more money. In Europe, and the rest of the world, 2005 was a record year for fund raising and investments.

However, it seem like 2006 will show an even higher level of fund raising and investments. So far, 2006 has been extreme in terms of deal volume, favourable pricing as well as borrower-friendly covenants. During 2006 the private equity (LBO) funds are expected to raise a record $ 300bn.[17] The buyout industry is not only getting bigger, but it is also extending its geographical playground. Originally a North American occurrence, LBOs are now becoming common around the world, mostly in Europe. In 2000, around 70% of all buyouts funds raised and invested took place in North America. Five years later, only 50% of funds raised and 40 % of investments were made in the US.[18]

The buyout phenomenon and its considerable reappearance in the 2000s is fuelled by three forces: lots of cash in the hands of institutional investors and wealthy individuals who want higher returns; a growing number of investment firms with track records in finding underperforming or undervalued public companies or units within those companies; and a strong economy that still has debt available at low interest rates. The following subsections will address these factors and other important drivers.

4.1.1. More funds available for LBO investments

As LBOs has been more and more accepted, pension funds and other large institutional investors have increased their portion of private equity investments. This has significantly increased the funds available for LBO investments. The rationale for pension funds to invest in private equity and LBOs are driven by the attractiveness of the private equity asset class. In a time when stocks returns have decreased to an average of 5-7% and bonds may actually yield non-positive returns (due to increased interest rates), private equity (LBOs) can provide a significantly higher return.

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[17] Platt, Gordon, Buyouts Keep Getting Bigger as Private Equity Firms Rush to Invest Billions Into New Funds, Global Finance (10/06) P. 92; (http://www.ultraviolet.co.uk/corporate-financing-focusbuyouts-keep-ge.html)

[18] http://www.ifsl.org.uk/uploads/CBS_Private_Equity_2006.pdf

Generally, pension funds have increased their allocation to private equity from 3-4% to 5-7% directly in a limited partnership and indirectly through fund-of-funds.[19] Since pension funds are the largest investor in buyout funds, this has to a large extent driven the LBO growth.

Due to the attractiveness of the private equity asset class in combination with the availability of funds, investors are eager to invest in LBOs. Today, there is actually a surplus of the supply of funds in relation to the supply of investments. This development drives the growth of the LBO market, but may also have a negative impact on the view of LBOs.

4.1.2. Private equity fund managers' track record

Perhaps one of the most important reasons for why allocation of private equity and buyout investments have increased is the track record the fund managers can demonstrate. Table 4.1.2.1. below clearly exhibit that the leverage effect can provide LBO investors with superior return compared to stocks.

Table 4.1.2.1. US LBO fund performance (% return for periods ended March 31, 2006)[20]

	One year	Three years	Five years	10 years	20 years
Buyout funds	25.5	17.6	6.3	8.9	13.3
NASDAQ	17.0	20.4	4.9	7.8	10.1
S&P500	9.7	15.1	2.2	7.2	12.1

4.1.3. Favourable interest rate and financing options

The 2000s has given us a low interest rate environment, one which is particularly suited for LBO funds. Because of this the power of the LBO funds have increased, which affects the capital markets. With a lot of money in the market, banks and other lenders have to fight to get a piece of the action. Debt terms are extremely favourable, and many lenders are offering looser loan requirements (e.g. *covenant lites*[21]). *Covenant lites* make bank loans, usually the first to be paid in a bankruptcy, behave more like high-yield loans in which bondholders have little say. 2006 has seen

[19] A *fund-of-funds* is a private equity fund that, instead of being used to make direct investments in companies, is distributed among a number of other private equity funds, who in turn invest the capital directly. By spreading the capital more widely, the risk to limited partners is reduced.

[20] Platt, Gordon, Buyouts Keep Getting Bigger as Private Equity Firms Rush to Invest Billions Into New Funds, Global Finance (10/06) P. 92; (http://www.ultraviolet.co.uk/corporate-financing-focusbuyouts-keep-ge.html)

[21] The covenant-lite structure means no financial covenants, or restrictions on the maximum amount of debt it can have relative to its cash flow.

a huge increase in the use of *covenant lite*. In the first quarter of 2006 five covenant-lite loans were announced, totalling $5.4 billion. To put this number in perspective, this equals 59% of all covenant-lite volume that has been tracked during the last 10 years.[22] The question is why banks are issuing this kind of financing. One simple answer is that bank loans are beginning to trade in the secondary market. The banks earn a fee for structuring the bank debt and then sells the debt in the secondary market.

However, covenant lites are not all bad. They often mean a company may take on less loan leverage to compensate investors for the extra risk they take and ensure they can walk away in the case of bankruptcy with full repayment of their investment. These arrangements save buyout funds money since they lock bondholders, out of negotiations until a covenant is broken, which only occurs when a company is unable to pay its interest.[23]

4.1.4. Regulatory changes

Often the waves of mergers and takeovers have been driven by changes in regulations. Even though this might not be the primary driver of the second LBO wave, there have been regulatory changes that have increased the possibilities for LBOs.

The constant scrutiny of being in the public eye can force managers to take non-optimal decisions. In the U.S. it has been claimed that the *Sarbanes-Oxley Act*[24], passed in 2002, has increased the incentives to take a firm private since it is very difficult to take risks and carry out major changes in a public company where public shareholders and governments carefully studies your every move.

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[22] The U.S. Leveraged Loan Market: Huge Deals, Few Bargains, Standard & Poor's, 24-Apr-06 http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp_article/ArticleTemplate&c=sp_article&cid=1145997542521&b=5

[23] http://www.efinancialnews.com/index.cfm?page=archive_search&contentid=1045699354&uid=4706-6211-110521-474953

[24] The Sarbanes-Oxley Act is a US law passed in 2002 in response to a number of corporate and accounting scandals. The legislation is wide and establishes new or enhanced standards for all U.S. public company boards, management. See http://www.sarbanes-oxley.com/

In Europe, the European Union court has ruled golden shares[25] illegal, since they are contradictory to the principle of free circulation of capital within the European Union. This ruling led to the large hostile LBO takeover of British Associated Airports (BAA).

4.1.5. Private equity funds forming consortiums

As a result of the fact that more money is available in the LBO market, the demand for larger investments follows. Despite the fact that the LBO funds are increasing, the investment criteria of the funds limit them from taking on large LBOs themselves (often an LBO fund can only allocate a maximum of 10% of the committed funds to one single investment). In order to meet the demand from their investors, they form consortiums with other funds, *club deals*. Generally three to seven funds form a *club*. By clubbing together the buyout funds can increase their fire power and spread their risk by participating in a larger number of deals. However, more importantly, they are able to neutralise competition for targets which keeps the prices down and returns up. This increases the share of the value creation that fall in the hand of the fund investors instead of the hands of the shareholders of the target firm. In line with this hypothesis, empirical finding suggest that LBO premiums have decreased from an average of 31% in 2001 to 19% in 2005.[26]

4.2. The Buyout

On July 24, 2006, the board of directors of HCA accepted a leveraged buyout offer by current HCA management, its founder and Hercules Holding II LLC, a consortium of private investment funds including Bain Capital Partners LLC, Kohlberg Kravis Roberts & Co. and Merrill Lynch Global Private Equity.[27] The offered price for the equity was $21.3 billion ($51 per share), which was notably lower than its five-year all-time high. Including the existing debt of $11.7 billion the enterprise value of the deal was $33 billion. The takeover included no hostility and no bidding war with other potential buyers[28]. On November 17, 2006 the takeover was completed and the HCA stock was de-listed from the New York Stock Exchange.

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[25] A golden share is a nominal (veto) share which is able to outvote all other shares in certain specified circumstances, often held by a government organization, in a government company undergoing the process of privatization and transformation into a stock-company

[26] http://www.sec.gov/Archives/edgar/data/860730/000095014406007665/g02663exv99wxcyx6y.htm

[27] The owners are the four following buyout funds: Bain Capital Fund IX, L.P., the ML Global Private Equity Fund, L.P., KKR Millennium Fund, L.P. and KKR PEI Investments, L.P.

[28] Even though the Blackstone Group also considered bidding for HCA

This is actually the second time that HCA is going private. In 1989 the management took the company private in a $5.1 billion LBO in order to cut costs and to eliminate the threat of a hostile takeover that characterized the 1980s takeovers. Three years later, 1992, the firm went public again. Today the firm struggles with descending earnings, slow growth and growing expenses for the uninsured and the buyers are looking to generate stable cash flows to repay debt and generate return to the owners. By eliminating the scrutiny from Wall Street, HCA will be more likely to focus on growth and cash flow rather than earnings. In addition to this, HCA is not in need of public financing. Since 2001 HCA has been a net *buyer* of its share, having bought back around $8 billion worth of stock.

As is often the case, the buyers will impose a highly levered capital structure in the post-LBO firm. HCA is proposed to be financed with 85.7% of debt, which implies that growth and improved cash flows will be needed to repay the high yield debt. Table 4.2.1. below shows the proposed[29] post-LBO capital structure of HCA.

Table 4.2.1. Capital Structure of the HCA LBO, with Equity Ownership[30]

	$ Millions	% of Total Liabilities	% of Fully Diluted Equity
Debt			
New senior secured debt	14,600		
New notes	5,400		
Existing senior notes	7,500		
Total Debt	27,500	85.7	
Equity			
Thomas Frist Jr (HCA founder)	690		15.0
HCA managment	47		1.0
Hercules Holdings II LLC	3,864		84.0
Total equity	4,600	14.3	100.0
Total Funding	32,100	100.0	

4.3. Managerial incentives & the agency problem

It is clear that the buyers of HCA will keep the present management team, but significantly adjust their objectives in line with LBO practice. In line with the theory of aligning management

[29] N.B. All the debt has not been issued yet, as of 2006-12-06

[30] http://www.sec.gov/Archives/edgar/data/860730/000095014406007665/g02663g02663z0116.gif

incentives with the incentives of the owners (Jensen and Meckling, 1976, Holmström and Kaplan, 2001 and Opler and Titman, 1993), the founder and management will have a significant equity stake. The six people in the management team will together hold 1% ($46.5 million) of the equity in the form of common stock & stock options.[31] In combination with the ownership of the HCA founder, the management group will have a significant stake (16%, $737 million) in the firm. Compared to the pre-LBO ownership structure, the management group has quadrupled its equity stake. This alignment of incentives is typical to LBO deals and is supposed to lead to a situation where HCA will be more likely to focus on increasing cash flow rather than earnings and long-term projects that could benefit the company's bottom line now compared to the constant scrutiny of Wall Street. This will be in the best interest of the shareholders, and hence the management.

Since the deal has just been finalized the supply of information about additional incentive systems is not available.

4.4. Discipline of debt

As given from Table 4.2.1. above, HCA will be loaded with a significant amount of debt (85.7%). In addition to the restructuring of existing debt in the company, the owners will raise another $16 billion to finance the acquisition. As is normal in an LBO restructuring, this will provide the management will incentives to act in the interest of the owners that can not be achieved by optimally designed compensation packages. The incentives will be largest immediately following the LBO and force restructuring decisions. In fact the management of HCA has already suggested that they will consider growth through acquisitions as well as potential divestments of underperforming hospital and divisions. These two actions are both primarily driven by the need to repay the most expensive (high yield) debt and to distribute funds to the owners. In the case of divestments, short-term cash flows from selling undervalued assets are generated, which can be used to reduce debt. The new owners have also received approval for distributing an extraordinary dividend of $365 million from HCA, which will further reduce the available funds for debt repayment and strengthen the discipline of debt.

In early November HCA announced to largest bond issuance ever, in which the majority of the $5.6 billion pays a coupon of LIBOR+275bp. Despite tax benefits of interest payments, the most

[31] http://phx.corporate-ir.net/phoenix.zhtml?c=63489&p=irol-sec&control_selectgroup=3,4,5

significant effect on HCA will be the debt distress which will force cost efficiency and a more slim organization. As a part of the restructuring of the entire company, we believe that HCA will be able to reduce overhead costs.

4.5. Active ownership

Because of the time, knowledge and money needed to manage the portfolio holdings active ownership is crucial for any LBO fund. Traditionally LBO funds have invested along with management and more or less completely controlled the company. The board of directors would then just be a formal tool for the LBO fund to make decisions regarding the company.

However, in the 2000s the club deals have become a common phenomenon. In the case of HCA four buyout funds invest jointly through an acquisition vehicle, Hercules Holding II LLC. Despite its advantages, as discussed earlier, this phenomenon comes with some negative implications. In the case of HCA, this club deal structure will affect the active ownership and control. It is not likely that all co-owners of Hercules Holding II LLC will be "running the show", since it would create overhead costs that are not consistent with the lean structure of an LBO organisation. Nor is it likely that they will hand over the control to the one of the other parties either.

Reuscher and Price (2006) argue that the stockholders agreement is an important part in outlining the relative rights of each investor post-closing. Governance arrangements are shaped by a variety of factors, including, bargaining position, expertise related to the target business, and, most importantly, each investor's respective equity stake. In the case of HCA the LBO funds have equal equity stakes. This may lead to conflicts regarding various issues such as approval rights, board representation and the allocation of the management fee[32] and carry[33] between the three.

In lack of detailed information about the HCA stockholder agreement and observed results of the ownership and control this subject will be further discussed in the comparison with its alternative, the single fund deal structure, in the next section.

[32] A fee charged by the manager of the buyout fund for managing the fund. Often 1-2% of committed capital

[33] Private equity firms generally receive a carry, an interest of 20% of profits above some target rate of return

5. Analysis: Comparison of the Beatrice and HCA buyouts

Now that we have gone through two of the most significant buyouts in each period, we can see some similarities and some differences that characterize the two waves.

In the case of Beatrice and the 1980s in general, companies often entered the 1980s structured as a conglomerate, and shareholder value was something relatively new. There were room for improvements in corporate governance and the new goal was having well run and efficiently structured companies, which created room for restructurings and buyouts. Holmström and Kaplan (2001) discusses that *"in some cases, the capital markets reversed ill-advised corporate diversification; in others, the capital markets helped to eliminate excess capacity; in others the capital markets disciplined managers who had ignored shareholders to benefit other stakeholders"*. Beatrice was to some extent proof of these happenings, although it was sometimes taken to an extreme. The asset sales were clearly a reversal of the corporate diversification that had taken place in the 1960s and 1970s, excess capacity was eliminated, and managers working in the interests of the owners were appointed.

In the case of HCA, and the 2000s in general, things have changed. Buyouts are less controversial and are no longer equivalent to corporate raiders tearing apart targets and laying off staff. LBOs are now an accepted means to generate significant improvements in companies. The typical LBO target of the 2000s is a stable firm with substantial cash flows. It may have divisions that will be divested post-transaction, but the realisation of "fast money opportunities" is no longer a critical determinant of a typical LBO in the 2000s. In general the targets are larger compared to the 1980s. This is mainly driven by the huge amount of supply of funds available from investors in the private equity funds, funds' track record as well as a debt capital market that is willing to supply financing at attractive terms (often with less covenants).

A new phenomenon in the 2000s is the concept of the club deal, where private equity firms form consortiums to perform larger LBOs and to spread their risk. Generally, the club deal is beneficial for the LBO investors. The club deal decreases the bidding competition, which lowers the takeover premium and increases return to investors. Hence, more of the value added from the transaction falls in the hands of the LBO investors. However, the club deal may lead to control and agency-related problems within the *club*. Such problems concern roles and responsibilities and free rider problems within the consortium. These problems will be discussed further in the section 5.3 below. In the following subsections we will try to analyze the

differences in LBOs of the 1980s and 2000s by discussing the three aspects discussed by Holmström & Kaplan (2001); managerial incentives, discipline of debt and active ownership.

5.1. Managerial incentives & the agency problem

During the decades preceding the 1980s, managers were not always focusing on shareholder value, so when pressure to do just this came in the 1980s, there were large opportunities for improvement. Shareholder activists and private equity firms were driving the change, and takeovers and LBOs played a big part in that process. The findings of Holmström and Kaplan (2001), Jensen (1997), and Opler and Titman (1993) are still current topics. LBOs are still structured in ways to align the interests of the owners and managers. In both Beatrice and HCA, managers are after the buyout owners of company stock.

Even though LBOs of the 1980s and 2000s are not different in the aspect of aligning incentives, it has an impact of the importance of the phenomenon of an LBO. Today executive compensation[34] is a much more a sensitive issue than in the 1980s. It receives a lot of media attention, and high compensation is generally seen upon as managers stealing shareholders' money. In line with the existing theory of the importance of realigning managerial incentives, LBOs are therefore more important today than during the 1980s. LBOs provide a mean to avoid the public scrutiny and resistance against the necessary high level of executive compensation. As a public company, the proper managerial incentives (Holmström & Kaplan, 2001) are less accepted. Hence, as a private (post-LBO) company, managers can therefore be compensated in a way that is consistent with shareholders best interest.

5.2. Discipline of debt

One of the main reasons for leveraging among private equity funds today as well as in the 1980s is the possibility of high returns on investments. Funds can go after large companies without having to put down more than a small portion of its entire fund.

In the 1980s when the LBO targets were well-diversified firms and conglomerates, there was more room for asset sales, which made it easier to pay back debt. This made it possible, and led to an eagerness to leverage even more. Leverage levels were sometimes so high that the firm ended up in default even when firm performance was improving. The debt level were too high.

[34] Primarily highly performance linked bonuses, stock and stock option contracts.

Generally, the debt levels were higher in the 1980s than in the 2000s. A typical LBO capital structure of the 1980s encompassed 80-90% debt while a typical LBO in the 2000s generally has 70-80% debt. In the case of Beatrice the debt level was 84%, which corresponds to a typical debt level in the 1980s. In the case of HCA the debt level is 86%, which is high for a typical LBO of the 2000s.

Hence, today investors need to be more careful with high debt ratios, since cash flows are of higher importance since buyers cannot rely on potential sales of non-core assets/divisions if cash flows are insufficient in the period following the buyout. However, due to the differences in the economic conditions, the role of debt and the discipline of debt are still crucial determinants of LBOs in the 2000s.

5.3. Active ownership

Today, acting in the interest of shareholders is very important for company management. Achieving increased active ownership through LBOs therefore plays a lesser role today. However, there is still room for improvement on the corporate level, since we see activist investors with minority holdings pressuring company boards to act in their interest. With a low concentration of ownership, the interest of the owners can become diffuse. Here, LBOs can still make a difference.

In comparing the two LBO waves we can see that we have a clear difference in this aspect. Still, LBO buyers are increasing the concentration of ownership and are actively participating in the business as they did in the 1980s. However, the structure on the buyer-side of the transaction is different. As discussed earlier the typical LBO deal of the 2000s encompasses consortiums of private equity firms, compared to a single firm in the 1980s. Since this phenomenon is rather new, there is little evidence of the results of this. However, we think that this might potentially lead to conflict among the buyout funds in the consortium regarding the future of the company, who should represent the consortium on the board, how the management fee should be distributed and *free rider*[35] problems. We think that this might be a critical factor in achieving a strong, clear and active ownership.

[35] Members of the buyer consortium might see a possibility to free ride, i.e. benefit from another party implementing the actual active ownership.

6. CONCLUSION

Private equity firms are still active and the funds they raise are larger than ever. If anyone thought that LBOs was a thing of the 1980s, they have been proven mistaken. We have through this thesis seen that the potential for change and improvement through restructurings and LBOs were vast in the 1980s. Corporate specific issues and regulatory changes were drivers in generating LBO activity. It was perfect times for the rise of the buyout industry. Post-buyout changes in the 1980s included having managers as owners of the company to align the incentives of managers and owners. The new owners were active with regards to the future of the newly acquired companies. We saw deals with significant amounts of junk debt, eliminating opportunities to spend cash unwisely. As a result of this companies were sometimes forced to sell assets to pay back debt, thus becoming more streamlined and efficient.

In the 1980s, buyouts were something new and revolutionary. Today, buyouts are not seen as exceptional anymore, more as a natural presence in the corporate environment. Managers of public companies are now forced by the market to run their companies efficiently, or they will risk being bought out by private equity firms who are looking for companies with potential for improvement. The private equity industry has to some extent also changed. It has grown and now contains many significant large players and many funds operating in the mid- and small cap markets. The amount of funds invested has also grown. Although the results of LBOs are the same as in the 1980s, the way they are executed is different. To decrease their risk, funds "club" together to acquire larger targets and junk bond financing is not used to the same extent anymore. Since maybe the potential for significant improvements in companies and for generating exceptional returns are not present to the same extent anymore, it seems like the private equity industry has gone more towards a "volume" industry, where scale is important to keep generating the high returns it has become accustomed to.

Through our case studies, we have seen that the results of LBOs are much the same now as it was twenty years ago. After the LBO, focus is on realigning managerial incentives to match the wishes of the owners. The debt levels eliminate the free cash flow problem and forces managers to act, through cost cutting or even asset sales, to make sure that debt is paid down. And the private equity firms make sure that the post-buyout company is progressing in the right direction through active ownership and increased governance. One potential issue that might have to be considered in the latter case is the impact of *club deals* on active ownership. With more funds

involved, one would expect that more wishes need to be considered. Since *club deals* are something relatively new, we will have to wait to investigate the implications of this issue.

We believe that companies have learned their lesson from the 1980s – to focus more on managerial incentives, active ownership, and to make sure that shareholders' interest is always considered. Hence, the three major results of LBOs, as suggested by Holmström and Kaplan (2001), are still valid implying that LBOs are still an important tool to improve companies and increase shareholder value.

6.1. Suggestions for further research

In carrying out this master's thesis a number of new questions have emerged which we suggest as research topics for future master's theses and/or further research.

First, it would be interesting to carry out a similar study in three to five years to get some perspective and added insight into the characteristics of the second LBO wave. Since we are in the middle of the wave right now, it is difficult to observe all the driving forces of the LBO activity.

Second, the fact that private equity firms are getting bigger and bigger comprise a big change on the owner side. The implication is that the private equity firms are becoming the conglomerates that they bought out and tore apart in the 1980s.[36] It would be interesting to research how this conglomerate structure affects the performance of the private equity funds as well as their ability to enhance value in their holdings.

Third, it would be interesting to investigate the effect that *club deals* have on the corporate governance of the LBO target. Will this new ownership structure affect the ability to monitor and be an active owner? It has been suggested that the *club deal* may lead to conflicts, free rider problems and addition cost and stress within the consortium. Will this new ownership structure affect the advantages of a buyout as suggested by Holmström and Kaplan (2001)? In addition, by forming consortiums, the concentrated ownership of the typical LBO is diluted. Are the advantages of concentrated ownership, as suggested by Shleifer and Vishny (1996), growing weaker or are they unaffected by the *club deal* structure?

[36] However, one important distinction is that private equity firms don't cross-subsidize bad poorly performing units.

Fourth, related to the concept of *club deals*, there has been a general discussion of the fact that private equity firms are demonstrating anti-competitive behaviour by forming consortiums since these generally decrease competition for LBO targets, which may be disadvantageous for LBO target shareholders. Some private equity firms are actually being investigated in this matter. A research question of interest related to this would be to investigate the effect on the LBO activity of a regulatory restriction, or ban, of club deals.

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