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The Operating Characteristics of Leveraged Buyouts: Empirical Evidence from Europe

This study examines the validity of dominating value creation theories surrounding LBOs and the identification of typical operating characteristics of European buyout targets. The European private equity mergers and acquisitions (M&A) market has grown to twice the size of the corresponding market in the US. Despite the increasing importance of the European buyout market, academic studies on buyouts focusing in the European region have been few. Most studies on LBOs have researched the US market in the 1980s.

The value creation opportunities of LBOs are discussed by comparing the theoretical framework surrounding LBOs. The theory that LBO firms suffer from agency problems of free cash flow is compared to the presented underperformance hypothesis that extends the traditional insider information hypothesis on LBOs. The underperformance hypothesis states that a company becomes an attractive LBO target because its operating efficiency can be improved without changing the scale of the operations of the target company

The aim of the empirical design is to test the explanatory power of these characteristics in explaining the probability of a company going through an LBO. In addition, the purpose of the research design is to test to what extent this probability can be explained with the presented hypothesis: the free cash flow hypothesis, the insider information hypothesis and the underperformance hypothesis. The methodology of the present study follows by and large the lines of prior studies and uses paired t-tests for differences in means, Wilcoxon signed rank tests for differences in medians and logit regression analysis for measuring the likelihood for LBO. The tested variables reflect operating characteristics of typical LBO targets and are measures for growth, cash flow generation, operating efficiency, liquidity and gearing.

This study focuses on European leveraged buyouts during the period 1997–2003. Using a sample of 71 LBOs, the results indicate that there exists a significant relationship between the operating characteristics of a company and the likelihood of LBO. The LBO sample is compared to 71 matched control groups of comparable companies as well as to a sample of 685 industry sub sector matched strategic mergers and acquisitions announced during the same time period as the sample LBOs. On average, when compared to industry peers and strategic transactions, typical LBO characteristics are relatively low EBITDA margin, relatively high cash flow volatility and relatively high operating profit and asset turnover. The results indicate that European LBO targets are underperforming their comparable industry peers and provide value creation opportunities through improved cash flow generation and execution of growth opportunities. This evidence is interpreted as inconsistent with the notion that agency problems associated with free cash flow would be the main driver for LBO activity. This inconsistency is assumed to reflect the competitive and capital market changes impacting LBO markets, which have changed the characteristics of typical LBO targets. Although not conclusive, the evidence justify support for the presented underperformance hypothesis.

This study makes three contributions. Firstly, this paper adds to previous research on pre buyout characteristics of LBO targets by extending the comparable samples of LBOs to both comparable industry peers (control group) as well as to strategic mergers and acquisitions. Secondly, this paper contributes to research on European LBOs by studying pre buyout operating characteristics using a sample of European LBOs. Thirdly, this paper provides empirical evidence on how the characteristics of LBO targets have changed since the 1980s, when agency problems associated with free cash flow were argued to be the main driver for LBO activity.