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The Positive Role of Private Equity and LBOs in Mergers and Acquisitions: A Response to the Negative Opinion

Zhilin Song[1,a,*]

[1]*East China University of Political Science and Law, Shanghai, 201620, China*
a. 100530@yzpc.edu.cn
**corresponding author*

Abstract: In western countries, after nearly 40 years of rapid development, private equity firms have used leveraged buyouts to perfection in M&A activities, yielding unlimited benefits for different subjects. Nevertheless, some people claim that, private equity and LBOs are unfair practices, which is harmful in many spheres. Especially in China, there are many problems behind the immature introduction of private equity. Therefore, to respond to these arguments, this essay aims to explain the positive aspects of private equity and LBOs, illustrate why these benefits can be achieved, and prove those negative views are unreasonable. Supported by some scholar's conclusions, statistics, and specific examples, it can be concluded that, private equity and LBOs are helpful to reduce agency costs, improve corporation value in targets, and create tax income for a country's Treasury. Moreover, they have little effect on unemployment, the insolvency risk caused by leveraged buyouts is manageable, and the transaction process of them becomes safer.

Keywords: private equity, LBOs, agency costs, target companies, tax revenues

1. Introduction

Private equity is an alternative investment method that invests in or acquires private enterprises not listed on a public stock exchange and engages in buyouts of public companies. Leveraged buyout is a considerably popular form of private equity acquisition, which means utilizing an outstanding amount of debts to finance a transaction. Private equity and LBOs have proven to be quite successful in many cases, for example, in 2006, a private equity fund called Pacific Alliance Group acquired 67.4% of the shares of Goodbaby Group, which was China's largest stroller manufacturer at that time, with a total value of 122.5 million dollars. To ensure the transaction went smoothly, PAG was well prepared. It conducted a thorough valuation of the target in advance and designed an ideal lever, leveraging 122.5 million dollars in M&A activities with only 12 million dollars of its own funds, equivalent to ten times leverage and the rest money was raised in debt. After purchasing Goodbaby, PAG renovated its corporate governance structure and implemented a series of integration measures, further enhancing the development speed of this enterprise and making it achieve the complete market dominance. While for PAG itself, it became the absolute controlling shareholder of Goodbaby, and it was anticipated to harvest huge profits after the company went public overseas. It can be seen from this case that private equity and LBOs are commendable tools, however, the debate over whether private equity and LBOs are commendable tools or unfair practices continues for a long time, for there are many scholars presenting persuasive arguments. Based on this, this essay will lay emphasis

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on the reason why private equity and LBOs are commendable tools, then show a fight back against several typical disapproval points, and finally give a brief introduction of private equity development in China, providing personal suggestions on how to make these tools function better.

2. Three Benefits of Private Equity and LBOs

Private equity and LBOs are commendable tools, because through using them, different subjects can reap the corresponding benefit.

2.1. The Reduction of Agency Costs

To start with, private equity and LBOs are ideal tools for company owners to lower agency costs. In 1932, two American scholars perceived the separation of ownership and control which troubled the modern corporate governance. This separation naturally sparked a discussion about the agency problem, for shareholders and agent-managers of a company usually have distinct interest demands. Specifically, shareholders obviously tend to maximize the value of the firm, whereas managers think more about self-interest [1]. In 1976, Jensen and Meckling put forward the concept of agency cost for the first time. From their perspective, agency costs consist of principal's monitoring expenditures, agent's bonding expenditures that prevent agents from engaging in detrimental issues for the business, and the residual loss [2]. After this, shareholders gradually realized that, to alleviate the agency problem and ensure the positive operation of the corporation, they had to pay agency costs to managers, inevitably resulting in some unfavorable expenditures.

Meanwhile, little by little private equity rapidly developed during this period. Same in 1976, three investment bankers from the famous Wall Street investment bank Bear Stearns partnered to establish an investment company KKR, specializing in mergers and acquisitions, which was the earliest private equity investment company. Then, KKR collected its initial private equity fund devoted to conducting going-private buyouts in 1978. A year later, it purchased a big public company with the method of leveraged buyout. This transaction was quite successful, cheered by numerous followers. With private equity getting more and more prevalent, scholars began to ponder the relationship between private equity and agency costs. Some of them harbored the perspective that private equity will create higher agency costs, like Bratton in 2008, saying that private equity managers take such high fees, subsequently incurring a huge layer of additional agency costs [3]. Nevertheless, some thought differently. For instance, in the same year, private equity had been complimented by Masulis and Thomas for applying some underlying mechanisms that reduced agency costs [4].

The reasons for the decrease of agency costs are, on the one hand, the management members who master the actual control of the private equity company are often required to invest a certain portion of their private property in an acquisition transaction by shareholders. As a result, they are endowed with considerable ownership positions in portfolio companies, thereby guaranteeing the consistency of shareholder and management interests to some extent. When there is a mutual stake, the management will be more incentivized to ensure positive functioning of the company, invisibly reducing agency costs. On the other hand, the highly indebted structure of takeovers through LBO transactions is another mechanism that effectively curtails agency costs. In Michael Jensen's opinion, free cash flows are the source of agency costs, because private equity managers may spend these excess cash flows blindly, which is detrimental to company's profits [5]. However, after the LBO, managers are faced with a lot more pressure to pay off debts and the bankruptcy risk, forcing them to wisely utilize the additional cash flows and efficiently operate the enterprise.

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2.2. The Improvement of Corporation Value

It is claimed that private equity and LBOs are helpful tools to improve the corporation value of target companies after the buyout. There is a fundamental strategy regarding the private equity model: the private equity firm acquires businesses which have the potential to prosper, ameliorates their situations, and sells them eventually to make profits. In this process, by applying industry and operating expertise, for example, the private equity firm endeavors to recruit professional talents with relevant expertise and experience, the comprehensive operating performance of those portfolio companies can be markedly boosted. Through this, the target company will embrace more excellent management, more rational operating strategies, more advanced productivity, more extensive market, and ultimately higher profitability.

Indeed, what the private equity firm brings to the target company in real life has proven to be lucrative and uplifting. According to some macro studies, buyouts lead to salient operating improvements for targets. By way of example, in a research of 76 completed U.S. private equity public-to-private transactions in 1989, Kaplan found that, three years after the acquisitions, the operating margin of those portfolio companies generally increased by between 10% to 20%, and the cash flow margin soared almost 40%. Consistent with the operating changes, their mean and median increases in market value were 96% and 77% post-buyout [6]. Another research of MBOs, which is a subcategory of LBOs, in the UK conducted by Harris et al. in 2005 demonstrated that, the total factor productivity of 35,752 manufacturing establishments soared after the buyout [7].

From a concrete example, the case mentioned in the Introduction presents some beneficial impacts of LBOs on target companies as well. Goodbaby Group, the business being acquired by PAG, was not only equipped with a refreshing management team and operation policy, but also a much brighter market expectation, with more than 70% shares of the domestic baby carriage market and 40% market share in the USA.

2.3. More Tax Revenue

Speaking of the third point, when the private equity firm conducts LBOs, it will generate more tax revenue for a country’s Treasury, and that is why private equity and LBOs can be perceived as useful tools. Well, some people may be wondering that, LBOs clearly have the possibility to curtail tax revenues, because when adopting LBOs, the private equity firm is purchasing with massive debts, which spawns the necessity of repaying capital with interest to the creditors, resulting in less actual operating profits, and the tax is mainly levied on these operating profits. Therefore, such situation may bring about net tax losses to the whole country.

To verify whether the above conjecture was correct, in 1989, Jensen et al. explored the influences of acquisitions on tax revenues of the U.S. Treasury and found that the revenues surprisingly ascended. According to Jensen’s nuanced and accurate calculation based on the data from leveraged buyouts during the period from 1979 to 1985, readers can speculate on the reasons for the tax increase. Firstly, after LBOs, target companies usually realize significant rises in operating income, and such extra income is the source of increasing tax revenues. Secondly, many of the creditors who finance LBOs are also taxed on the interest income from LBO debt payments. Thirdly, acquired portfolio companies contribute to tax revenues by exploiting their capital more efficiently. After the LBO transaction, because of the highly indebted structure and the latent insolvency risks, employees in targets will have stronger incentives to maximize shareholder value, for instance, they have the tendency to eliminate wasteful capital projects that would have been undertaken without a buyout. Then, these saved funds will flow to shareholders, who can invest them to earn a more taxable return. Fourthly, in practices, a great number of LBO firms choose to sell off assets, triggering additional corporate taxes on the money gains [8].

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Overall, in real cases, the tax created by LBOs for a country offsets the tax underpayment due to the adoption of leveraged buyouts. What is more, there are superfluous tax revenues, leading to the thriving of national financial condition.

3. Responses to Oppositions

As mentioned in the Introduction, some scholars insist that, private equity and LBOs are completely unfair practices, for they cause unemployment, bring bankruptcy risk, and are difficult to be regulated. However, these views may not be discreet enough, and there are some evidences to prove it.

3.1. The Insignificant Effect of LBOs on Unemployment

It is often claimed that, once the private equity firm gets control of a poorly run target company, it will clean up the target through massive workforce reduction to save costs and achieve a benign restructuring of the company. Consequently, LBOs are seriously criticized for decrease in the number of employees in target companies [9]. Nevertheless, a wide range of studies imply the insignificant influence of LBOs on unemployment.

For example, in 1990, Lichtenberg and Siegel studied 1,100 manufacturing plants which were involved in leveraged buyouts from 1981 to 1986, finding that although the labor and capital employed of these businesses still had the inclination to decline after the acquisition, the rate of decline was slower than before the acquisition [10]. Then in 2008, the research conducted by Davis et al. demonstrated that, the general net job losses were less than 1% of the employment situation before the buyout. The whole team analyzed roughly 5,000 U.S. target companies bought in private equity transactions between 1980 and 2005, and about 300,000 U.S. establishments run by these companies, namely, target establishments. They uncovered that, employment did shrink more rapidly in target establishments than in control groups after the private equity buyout, and employment growth at controls also surpassed that at targets before and after the acquisition. Nevertheless, when it comes to the target firms themselves instead of the target establishments operated by them, bigger job gains in the form of greenfield job creation in targets can be witnessed, largely countervailing the bigger job losses in target establishments in the wake of LBOs [11]. Four years later, by choosing a distinctive data set of 533 LBOs collected during the period 1993-2004, Amess and Wright drew a conclusion that, acquired companies virtually maintained the same level of employment compared with a control sample of firms, powerfully responding to the arbitrary unemployment theory [12].

3.2. Controllable Bankruptcy Risk

It is widely known that, when adopting LBOs, the private equity firm takes advantage of considerable debts as a lever to increase ROI. It seems to be financially lucrative, while once the acquired portfolio companies cannot produce sufficient cash flows to service the debt, a bankruptcy crisis will come. Researchers Ayash and Rastad studied the sample comprised 467 LBOs conducted by private equity firms from 1980 to 2006, finding that within 10 years after the buyout, compared with the bankruptcy rate of 2% in the control group, those LBO target companies underwent a much higher bankruptcy rate of approximately 20%, thereby saying that LBOs aggravate the probability of insolvency in target companies tenfold [13].

Despite the statistics above, the possible bankruptcy risk caused by leveraged buyouts is not formidable indeed. To start with, this research only relies on a restricted sample, probably with a strong contingency. Besides that, according to their paper, these bankruptcies tend to take place in specific industries, especially the retail sector, which is hit the hardest, showing that bankruptcy risk is fully manageable in most industries. More importantly, a series of measures can be taken to prevent the occurrence of insolvency risk. For example, the private equity firm should attach significance on the

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choice of LBO target companies. The selection of target enterprises should be based on objective, thorough, and scientific analysis and evaluation, namely, their financial situation should be seriously analyzed and evaluated to ascertain whether the target satisfies the financial standards of the bidder and to what extent it can adapt to the bidder's financial status. Also, the private equity firm can establish a complete set of internal risk control mechanism, specifically, building a set of risk sizing indicators for acquisition-induced insolvency risk. This set of indicators will be utilized as a standard to determine the scale of the acquirer's debt, controlling the amount of indebtedness within a safe range.

3.3. Enhancement of Transparency

Since private equity funds do not have strict information disclosure requirements, information opacity can be the biggest issue criticized by investors. In a transaction, all the processes involving investment operations and management, such as investment proposals, fund transfers and project tracking management, may not be transparent enough, probably harming the interests of investors. Fortunately, in fact, there are many legislative initiatives that regulate private equity, greatly increasing the level of disclosures.

One of the most representative provisions is the Dodd Frank Act, which systematically monitors the U.S. private equity industry for the first time. Title IV of this act obliges the traditionally secretive private equity industry to provide regulatory institutions and public investors with its operational information. Therefore, the accumulation of systematic risk in the financial system can be timely monitored by regulators. Concretely speaking, to begin with, title IV requires all the private equity fund managers to register as investment advisers. In the past, managers who did not show the identity of fund manager publicly and had less than 15 clients within a year could avoid registration with the SEC. After the implementation of this act, every fund manager will be subject to the enhanced transparency requirement. Furthermore, according to the act, fund managers are ordered to keep specific reports and records for each private equity fund they administrate, and make them available at any time to the SEC for inspection. When the SEC obtain these reports and documents, it should share them with the Financial Stability Oversight Council, an organization aimed at supervising risks in the U.S. financial system, which reduces the private equity investment risk for anxious investors to some extent [14].

4. Private Equity in China

4.1. Development Process

Since reform and opening-up in 1978, China's economy has maintained a continuous growth momentum, and there are a great quantity of small and medium-sized enterprises developing rapidly in various industries. Their common feature is that they have unparalleled potential for advancement in the future, are in a state of thirst for funds, and are quite eager to invest in new capital. Under this background, an increasing number of foreign private equity investment flooded into China, trying to seize some profitable business opportunities. In 1992, the first foreign investment institution, the International Data Group (IDG), entered China, opening a brand-new era of domestic private equity investment. Guided by the more mature foreign private equity, in 2006, with the enactment of The New Partnership Law, the limited partnership organization form pervasively used by international PE funds had been realized in China, which vigorously promoted the development of this industry. Seven years later, the promulgation of a series of regulations made the supervision system of private equity investment clearer, and the PE fund in China was marching towards a growing standardized road

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[15]. At the end of 2019, China's private equity funds had accumulated 11 trillion yuan under management, and the scale of newly raised funds in 2019 was 1.24 trillion yuan, making it the second largest private equity market worldwide [16].

In general, China's domestic private equity fund has progressed a lot over the past thirty years. It has a wider range of funding sources, particularly various traditional financial corporations have also participated in the private equity market with a discreet attitude; it has a gradually improved organizational form, which is little by little in accordance with international standards; it involves in more pluralistic investment fields, such as modern financial service industry, real estate industry, and electronics industry.

4.2. Problems and Solutions

China's private equity investment industry does show a bright prospect of development, whereas problems exist as well. In fact, the domestic provisions and policies regarding private equity are not normative and unified enough, for different regions and departments possibly conform to different local legal policies on the supervision of private equity investment funds, resulting in large disparities of the interregional monitoring and punishment level, which may bring thorny legal and financial issues to investors. Besides that, there is still an insurmountable gap between China and western countries in terms of the number of top-notch and experienced private equity investment practitioners, and the fund management level. In response to these two problems, the following countermeasures may be feasible.

For the first worry, China should make scientific modification and integration of existing laws and regulations, and strive for enacting a new standardized management law of private equity investment funds as soon as possible to establish a well-ordered legal environment and powerful protection mechanism for different participants in private equity investment. For those investors who do not comply with normative laws and regulations about private equity, severe penalties should be resolutely imposed, such as fines and off-limits industry. When it comes to the other problem, China should focus on the cultivation of professional talents and the enhancement of the management level of private equity funds. To be honest, the optimal option at this stage would be, not only laying emphasis on raising the specialized skills of current practitioners in China, but also attracting western talents by enlarging market and providing them with a variety of preferential policies. Only by amassing valuable investment experience with the assistance of foreign specialists can the employee's quality and management level of China's private equity industry be increasingly advanced [17].

5. Conclusion

Private equity and LBOs can be undoubtedly perceived as commendable tools. They are popular all over the world, creating multifaceted benefits from diverse perspectives. For company owners, private equity and LBOs are conductive to reducing agency costs, because of the conferment of ownership positions in portfolio companies on management members and the stress of insolvency after a leveraged buyout. For target companies, acquired by private equity firms helps to greatly improve their corporation value, such as the refinement of operating strategies, the expansion of business scope, and the optimization of management level. For a country, its tax revenue can be significantly boosted by a LBO transaction, due to the emergence of various types of new taxable income after buyout. Speaking of some people's prejudice against private equity and LBOs, this essay also makes some reasonable responses. According to some statistics and examples, it can be considered that private equity will not cause serious unemployment problems, the bankruptcy risk brought by the highly indebted structure of LBOs is completely controllable, and all the processes involving private equity transactions are getting more and more transparent. When it comes to the situation of private equity

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in China, with the guidance of foreign experience, it has developed a lot and plays an important role in modern financial market. However, problems seem to be inevitable, the country fails to make some normative provisions and policies monitoring the private equity, and is lack of brilliant fund management talents. Notwithstanding the obstacles encountered, China can solve these problems through the methods of regulation formulation and personnel training. The ideal prospect is, China can finally explore a pattern that is in harmony with the country's basic national conditions to better realize the sustainable development and the effective circulation of capital through the channel of private equity and LBOs.

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