5 Management Buyouts as a Response to Market Pressure

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5.1 Introduction

The early 1980s have witnessed a dramatic increase in management buyouts of public companies. In these transactions a team of investors including the managers borrow the money and buy the shares of the firm's public shareholders. Equity in the private company emerging from this transaction is owned by managers, investment bankers, institutional investors such as insurance companies, and sometimes Employee Stock Ownership Plans (ESOPs). But equity constitutes only a small fraction of capitalization: debt-equity ratios typically range from 6:1 to 12:1 (hence the term leveraged buyout). A management buyout (MBO) is a particular type of leveraged buyout in which management participates in a buyout of shareholders of a public corporation, as opposed to a private company or a division of a public or private company.

When an MBO takes place, shareholders earn a 50 percent premium on average and managers often take money out and still end up with larger equity stakes (in dollar terms) than they previously held. The sponsoring investment bankers pocket high fees and commonly realize 50 percent annual returns over five to seven years on their equity investment in

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the new firm. With everyone doing so well, it is not surprising that management buyouts have grown.

And grow they have. While the first $100 million transaction did not occur until 1979, transactions in the hundreds of millions of dollars became common shortly after that, culminating in the $5.4 billion buyout of Beatrice Foods in 1985. The total dollar volume of transactions has increased from $1 billion in 1980 to $10 billion in the first six months of 1984 and is certain to be higher now. It is clear that the management buyout today is a relevant option for all but the very largest American corporations.

The amount of money changing hands in MBOs—whether going to shareholders, to managers, or to investment bankers—has promoted both curiosity and concern. Why are MBOs happening now, and in such large volume? What are the sources of gains that account for 50 percent or, in the case of MBOs in which several bidders are involved, 70 percent premia? Is it true value creation, or just value transferred from the old shareholders and the taxman? If it is value transfer, is the government footing the bill or are the selling shareholders getting ripped off? If, in contrast, value is created through cost-cutting and more responsible capital budgeting, why do we need MBOs to get this accomplished?

In this paper we attempt to describe and interpret what has been happening recently in a way that addresses these common questions and concerns. While data on private firms are hard to come by, and the skimpy data that exist have not been completely analyzed, some insights are beginning to emerge from case studies. In a nutshell, our interpretation of the evidence runs as follows. Inflation, tax law changes, and innovations in the market for risky, unsecured debt in the early 1980s have created new opportunities to increase value. Market values of many large corporations could be raised through recapitalizations, takeovers, and by other means. While some firms responded to the changing environment by voluntarily changing their operating strategies and financial structures, other firms faced a hostile takeover. In response to these threats, some management teams, committed to the perpetuation of their own control, undertook management buyouts. We therefore view many of these transactions as a response
to the market pressure to restructure and recapitalize. While management buyouts accommodate the financial pressures of the market, they also allow incumbent management to continue running the business. Interestingly, the viability of the MBO as a takeover defense has been bolstered by the same capital market developments and tax advantages that have increased the pressure coming from hostile takeovers. We believe that these facts are responsible for many of the MBOs of the 1980s.

In the rest of the paper we develop this argument in greater detail. In section 5.2, we review the changes of the late 1970s and early 1980s and try to document the experience in the market for corporate control that we believe is a response to an excessively slow adjustment to changes in the environment. We show how that environment put pressures on firms and in many cases led to challenges to the control of incumbent management. Management buyouts have enabled management to defeat many of these challenges while still dealing directly with the problems that sparked the challenge. We also attempt to summarize the evidence on the question of the source of MBO gains, since tax savings, deviation of market prices from fundamental values, and efficiency gains all seem plausible. In section 5.3, we recapitulate our view of the MBO as a defensive response to market pressures and we discuss its consequences for economic efficiency.

5.2 An Explanation of Management Buyouts

5.2.1 Changes in the Economic Environment

The structural changes in the American economy in the late 1970s and early 1980s have increased the ease and profitability of acquiring old corporate assets. This has precipitated many forms of corporate control transactions, among them management buyouts.

One of the most important shocks hitting the economy in that period was inflation. As amply documented by Feldstein (1983), it had significant effects on the value and the deployment of corporate assets. First, inflation raised the nominal value of corporate assets above their historical cost. This cre-
ated the opportunity to buy used assets and to depreciate them from scratch with a large step-up in basis. Such "churning" transactions became all the more attractive with the Economic Recovery Tax Act (ERTA) of 1981, which allowed for accelerated depreciation of newly purchased old assets as well as completely new assets (see Gordon, Hines, and Summers 1986). With only a small depreciation recapture and a large step-up in basis, churning used assets became an attractive option.

These transactions are especially advantageous from the tax viewpoint if the company selling assets is liquidated. Under the General Utilities doctrine (repealed in the 1986 tax reform), asset sales accompanied by liquidation are free from capital gains taxes at the corporate level. Thus, if a seller of assets survives as a corporate entity, it must pay taxes on capital gains realized from this sale, whereas if this seller liquidates in the process, such taxes are avoided. Not surprisingly, this provision has encouraged the churning of whole companies.

A second important consequence of inflation was the substantial reduction in real corporate debt obligations. Since interest payments were not indexed, a few years of rapid inflation substantially reduced the outstanding debt. This had two important effects. First, firms were ripe to lever up and take advantage of tax shields associated with the deductibility of interest payments. These interest tax shields may have also increased in value with the inflation-driven decline in depreciation tax shields. After several years of inflation, firms were clearly operating below their debt capacities. Second, the free cash flows of many corporations that were not too adversely affected by the reduction in depreciation tax shields may have increased as their revenues kept up with inflation while interest payments did not. As pointed out by Jensen (1986), the existence of large free cash flows can lead to corporate waste and self-interested capital budgeting decisions by management. While debt has the effect of encouraging managers to run a tight ship to meet their interest payments, the absence of debt gives them the freedom to waste money. By reducing real corporate debt obligations, inflation may have created both the opportunity and the need to lever up.

In addition to inflation, two other changes bolstered the market for corporate control. The first was improved borrow-
ing opportunities, especially through the use of unsecured debt. Access to increasingly large pools of institutional funds through bank loans, junk bonds, and other arrangements made borrowing possible in many cases where it would not have been five years earlier. It is quite likely, of course, that the development of these markets was in part a response to the needs of corporate control transactions. Another tax strategy that encouraged MBOs was the use of Employee Stock Ownership Plans. The 1981 ERTA raised the capacity of the ESOPs to borrow money from a bank, buy the firm’s shares and then deduct both interest and principal payments on the loan. Effectively, this enabled the firm itself to deduct the principal on its debt, as long as that debt was channeled through the ESOP. To make ESOPs even more attractive, Congress passed a bill in 1984 allowing banks to deduct half of their interest income from loans to an ESOP. Some of this saving is undoubtedly passed on to the firm.

Inflation, better capital markets, and tax laws of this period created substantial opportunities for corporate raiders or incumbent managers to raise shareholder wealth through restructuring and recapitalization. Value gains could be realized by closing plants, curtailing diversification strategies, levering up, churning assets (especially whole companies), and bringing in ESOPs. Changes in the environment not only increased the pressure from hostile takeovers, but also made the management buyout a more viable defensive option, since better borrowing opportunities and large tax gains subsidized these transactions.

5.2.2 Management Response

Many companies voluntarily adopted value-increasing changes. Depressed stock prices and tax gains were probably sufficient to motivate these firms. But levering up and eliminating slack is not a proposition that is costless to management. Life becomes more difficult as management faces the constant pressure of meeting debt payments, the high cost of financial distress, and the loss of control over free cash flows. Furthermore, a management initiating an MBO puts the firm into play and may raise the probability of its being acquired in a
hostile takeover. As a result, many management teams have chosen not to increase leverage to value-maximizing levels.

When hostile takeovers threatened the continuity of their control, target managements responded with the MBO (among other defenses, such as greenmail, scorched earth, and poison pills). Although executed under pressure, this transaction nonetheless accomplishes two goals. On the one hand, the enterprise survives as an independent entity under current management. On the other hand, tax and other benefits are realized, thus relieving the pressure for change.

5.2.3 MBOs as a Response to a Hostile Threat

The cases we have looked at largely support the proposition that MBOs are often a response to a hostile threat. We focused on the set of companies that were part of the Fortune 500 in 1980 and were acquired sometime between 1981 and 1984. We found that, of the eleven successful MBOs, six were responses to direct hostile threats, expressed either as actual tender offers or as acquisitions of shares with an intent to influence corporate decisions. In the subsample of seven failed MBO attempts, three were (unsuccessful) responses to the threat of a hostile takeover. At least for very large firms, the primary impetus behind the MBO is often not the prospect of making a large acquisition profit, but rather the threat that someone will do so at management's expense.

Perhaps it is evidence of the sweat and pressure following a successful MBO and of the risks of being outbid by a hostile raider that a significant number of MBOs are initiated only after a hostile threat. The drawbacks to such a takeover must be significant from management's point of view, for virtually every analysis of MBOs has found that value gains from these transactions are fairly large. DeAngelo, DeAngelo, and Rice (1984) find an average premium of 56 percent over the day earlier share price. Lowenstein (1985) in his sample of twenty-eight MBOs with purchase prices over $100 million also finds a 56 percent premium. In our sample of eleven successful management buyouts of Fortune 500 firms, we find an average premium over the day earlier market price of 53 percent. These results are consistent across samples, and are also similar to the findings for interfirm cash tender offers.
5.2.4 Sources of MBO Gains

Given the large premia being paid by investment bankers and institutional investors in MBOs, there seems to be a strong presumption that there are either large value gains from the new financial and ownership structure or large gains based on hidden values in the pre-MBO company. The three sources of gains that we think can plausibly account for a significant portion of the premium are: tax savings, improvements in efficiency (which would include value-increasing liquidation), and pre-MBO underpricing of the firm’s equity relative to the old regime’s expected future cash flows. Because the relative significance of these three sources of gains has been widely debated, we will examine their importance in some detail below, and give a few examples. First, however, we need to stress two important points that put these discussions of MBO gains in perspective.

The existence of potential gains from acquiring and/or re-structuring the firm is what attracts a hostile bidder in the first place. It is therefore not surprising that these gains might be large; otherwise the hostilities might never have started. But the exact source of gains that has precipitated the hostile takeover is not necessarily the same as the source of gains from the defensive MBO. For example, a hostile takeover launched in order to force management to shut down unprofitable capacity may be defeated by a higher offer from MBO organizers who plan to get a larger portion of their value gains from tax benefits of leverage. Conversely, even when the initial impetus behind the MBO is a hostile tender offer designed to realize gains from market underpricing or tax savings, we would expect management to strive harder to cut costs and increase efficiency in the highly levered and more closely held new firm. Having paid a large premium, MBO organizers must find ways to realize value when constrained to meet large debt payments. Competitive bidding in the market for corporate control, and debt-equity ratios that range from 6:1 to 12:1, mean that this constraint is likely to be binding.

The other point is that the exact nature of the gains in an MBO bears little relation to whether or not the public shareholders have been coerced to sell. Whatever the source of gains, some coercion is quite likely to have taken place, in the
sense that the public shareholders could not completely share in the expected gains realized after the MBO. The issue of coercion is thus different from that of MBO organizers buying underpriced shares. The latter applies when shares are acquired at a price below their fundamental value under the old regime. Coercion takes place when public shareholders would rather keep their current share of the post-MBO firm than take the price being offered. One way, but not the only way, for this to happen is if shareholders are forced out at a price which exceeds the prevailing market price but still falls short of the value of expected future dividends under the pre-MBO operating strategy.

The extent of coercion—whatever the source of gains—is hard to gauge. In the substantial fraction of cases with competing bids, there is reason to believe that, as in any auction, much of the gain accrues to those selling. In these cases, there is little coercion. Even when a bidder other than management does not surface, management's bid may have been set sufficiently high so as to deter the entry of competing bidders. Again, this would give most of the gains to public shareholders.

It is important to realize, however, that for an MBO to be profitable for its organizers, there must be some coercion—meaning that public shareholders do not capture all of the gains. Otherwise, what's in the deal for the organizers? While there is little real evidence on exactly how gains are shared between the organizers and public shareholders, there is some anecdotal evidence that managers do not volunteer to give up all of the gains.

For example, when Mr. Stokely attempted to take Stokely-Van Camp private, he offered $50 for shares that were selling for $38 prior to his bid. Eventually, however, the company was sold to Quaker Oats for $77, suggesting that perhaps Mr. Stokely had not offered all of the gains to his shareholders. In the same spirit, the management of Norton Simon originally offered $725 million for the company which fell far short of Esmark's $1 billion winning bid. In line with these stories, Lowenstein (1985) reports that average premia are 70 percent for successful MBOs in which three or more bidders are involved as compared to 50 percent for cases with fewer than three bidders.
In addition there is strong evidence for the incumbent advantage view, meaning that insiders have superior access to information as well as other strategic advantages in a takeover battle. Easy access to information is especially important in obtaining financing and ensuring profitable operation of the firm from the very beginning (which is a virtual necessity when the firm is highly leveraged). Other strategic advantages of the insiders include the ability to unilaterally lock up key assets (the crown jewels) with a friendly third party and having a much better chance of setting up an ESOP.

While the incumbent’s advantage over other bidders somewhat limits the extent of protection afforded old shareholders by the competitive bidding process, aspects of that advantage also make for superior value gains from a properly structured MBO as opposed to a hostile third-party takeover.

**Tax Gains**

Having said all this, we return to a discussion of the sources of value gains. The most commonly discussed source of gains in MBOs is value transferred from the taxman (Lowenstein 1985), through deductibility of interest, step-up in asset basis for depreciation purposes, and the ESOP. To illustrate the magnitude of these potential tax savings, we consider four well-publicized examples.

Shareholders of Congoleum, Inc., were bought out in 1980 for $448 million, at a 50 percent premium over market. The estimated step-up in basis was $350 million against $26 million in recapture. Needless to say, tax savings were large.

Norris Industries went through an MBO in 1981 for $420 million, at a 48 percent premium. In the first year after the MBO, depreciation deductions increased to $33 million from $18 million a year earlier. Interest deductions increased to $62 million from $1 million the year before.

When management took Signode private in 1982 for $430 million (29 percent above market value one day earlier), they wrote up assets from $150 million to $300 million, thus raising total annual write-offs from $20 million to $60 million.

Dan River used its ESOP to buy 70 percent of the new company’s equity. According to Lowenstein (1985), $100 million out of the total purchase price of $150 million could be
ascribed to various tax savings, the premature liquidation of pension plans, and other sources unrelated to the company’s operations.

**Underpricing of the Firm’s Equity**

While the evidence for the importance of tax gains is fairly abundant, the case for the importance of underpricing of the firm’s equity relative to fundamental value is much more tenuous. First, it runs counter to the efficient markets hypothesis, which has been the bedrock of financial economics for many years. Recent critics of that hypothesis include Black (1986), who now calls the market “efficient” as long as the price is within a factor of two of fundamental value. If financial markets are highly efficient, the notions of the bear market of the late 1970s and of cheap stocks in basic industries are not very persuasive. Even if they are not efficient, the gains from MBOs are still bounded by the size of the informational inefficiency in the market.

Weaker forms of the efficient markets hypothesis are consistent with managers having special information about their companies that enables them to know when their firms are underpriced even when the stock price is fully rational based on the market’s limited information. Although such informational asymmetries would give managers an opportunity to buy undervalued companies if they could buy secretly, it is important to recognize that management’s bid itself conveys a lot of information. Moreover, information is revealed when the MBO organizers try to obtain junk bond financing. In a competitive corporate control market, such information revelation severely handicaps the effort to profit by acquiring undervalued firms. Even absent competing bids, the information released after management’s offer can raise the acquisition price enforced by the courts substantially above the prebid market price.

A commonly argued version of the asymmetric information view states that managers distort pre-MBO earnings to make the company appear unattractive, thereby enabling themselves to buy it for less. As a test of this view, Linda DeAngelo (1986) looked for abnormal earnings accruals prior to MBOs and found no evidence of significant misrepresentation of earnings.
It is very hard to say whether companies bought out by management are systematically underpriced. What we can say is that Value Line's 1980 write-ups of the twelve firms in our Fortune 500 MBO sample suggested that the share prices of many of these firms contained substantial room for appreciation. For example, Value Line thought that eight of our twelve companies had very good long-run capital gains prospects and that three out of twelve had moderately good long-run prospects. At the same time, Value Line did not think that short-term prospects were good for any of our companies. While the write-ups from Value Line hardly constitute strong evidence for irrational valuation by the market, they do suggest that these MBO targets were valued below their potential. Interpreted broadly enough, this observation may be hard to dispute, especially given the premia ultimately paid.

Efficiency Gains

Last but not least, we turn to a discussion of true value creation in MBOs, recognizing that the economic evaluation of the MBO turns crucially on the realization of efficiency gains. Both tax savings and buying underpriced shares from shareholders are examples of transfers of value between parties and not of true value creation. While such transfers change the distribution of the pie, they do not affect the size of the pie. The question of value creation is whether or not MBOs make the pie bigger.

In discussing value creation, the first thing to note is that the ownership and financial structure in MBOs is heavily geared toward providing managers with incentives to squeeze additional value out of the firm's assets. Such motivating arrangements come in three forms.

First, managers are given large equity stakes in their firms, which raise their personal benefit from improving efficiency. Lowenstein (1985) found in his sample of large MBOs that management's percentage ownership rises from a median 3.8 percent prior to the MBO to a median 10.4 percent after the transaction. The latter number is consistent with the finding of Mörck, Shleifer, and Vishny (1988) who, in a cross-section of public Fortune 500 firms, identified 5–10 percent as the range of management ownership associated with the best performing firms. MBOs thus give managers big enough per-
percentage stakes to provide the right incentives, but not big enough to confer complete control.

In the vast majority of these cases, managers do not pay for these equity stakes out of their own pockets. In fact, they could not afford such investments in many instances. In most MBOs, managers are just given these large equity stakes for virtually no money.

While equity stakes seem to be given to the managers with the intention of motivating them to work hard, there is always the stick in addition to the carrot. As stressed in the free-cash-flow theory of Jensen (1986), the necessity to meet debt payments focuses the minds of managers on realizing the firm's full potential, since default and renegotiation can cost them their independence and possibly their jobs.

Last but not least, investment bankers usually also own a substantial amount of equity in the firm and are often capable of firing managers who are not performing as expected. It is conceivable that having an investment banker breathing down the manager's neck is as good a motivating device as equity ownership.

These last considerations may suggest why managers might not jump into MBOs without a hostile threat, despite the potential for large financial rewards. After an MBO, managers lose much of their control over free cash flows as well as the ability to run their firms without outside interference, for at least a few years. While it is good to be rich, it is also good to be free.

Granted that managers are motivated to improve operating efficiency, what can they actually accomplish? Although hard evidence is not abundant, belt-tightening measures typically seem to include the shortening of accounts receivable collection periods, decreasing inventory-to-sales ratios, insisting on better deals from suppliers, cutting capital expenditures, and cutting employment. (In a sample of 200 British firms, for example, the average employment cut was 18 percent subsequent to an LBO. This was not the result of management cuts, which were not very large. See Wright and Coyne 1985.) While some of these methods for increasing efficiency do not seem very revolutionary, it is important to realize that many of the target companies are in fairly competitive industries
with low profit margins to start with. Small cost savings in these companies can add up to a vastly improved return on assets.

Norris Industries is one case for which we have information about some of the belt-tightening measures. After the MBO, Norris liquidated $50 million in inventory and stabilized at half of its pre-MBO inventory-to-sales ratio. It also required customers to pay their bills in forty rather than fifty-five days. Finally, Norris sold a division for $34 million, taking a $3 million write-off. While these measures undoubtedly created some value, the Norris case is interesting in that something beyond cost cutting was clearly going on. While the MBO transaction took place at approximately 1.6 times tangible book value, twenty-two months later Norris was reoffered to the public for approximately seven times book value. According to McGuire (1984), Norris is one of a group of companies going public in the hot new issues market of 1982–83 shortly after going private, whose huge successes were largely the result of paper transmutations, in other words, value transferred from old, and, particularly, new public shareholders.

The example of Norris is suggestive in that, although value creation may not have been the initial impetus for the MBO, nontrivial efficiency gains were nonetheless realized. Even when tax savings and the informational inefficiency of the market create the opportunities for large value transfers, the MBO deals that are ultimately struck are still structured so as to provide superior incentives for value creation.

5.2.5 Effects of Risk

The existence of tax savings, underpricing, or the potential for efficiency gains are not the only important characteristics of an MBO candidate. First, the increased financial risk incurred by the highly leveraged post-MBO firm means that business risk should be low. A company operating in an unstable environment in which its cash flows are subject to large fluctuations cannot take on 80–90 percent debt and still be fairly certain of meeting its regular payments. Furthermore, management’s obsession with the financial side, along with limited access to new financing, make growth and concentration on areas such as product development and marketing
quite difficult. If these areas are important sources of future profits, an MBO may be ill advised. Consistent with these limitations, MBOs typically occur in mature industries with stable cash flows, such as food and textiles. Of course, the step-up in basis for depreciation purposes can also be more dramatic for older firms which, as cash cows, are also more likely to offer large value gains from restricting management's access to free cash flows.

The requirement of stable cash flows to meet debt payments also explains the necessity of retaining the experienced incumbent management team, a strategy which is unlikely to bring a big positive surprise but is equally unlikely to bring a big negative surprise. It is the latter factor that matters for debt payments. The importance of the experience and continuity of the management team in an MBO may also help to account for the great deals that managers strike when equity is divided up.

While MBO organizers bear substantial risk, they also enjoy large upside potential. After the five to six years in which the debt is being repaid, the firm belongs to equity holders. Management in this case would typically own a 10-15 percent stake in a debt-free firm. If efficiency gains are realized, cash flows are likely to exceed the amount needed to meet debt payments. In a company operating with a substantial amount of slack prior to the buyout, these gains can be quite large. Finally, even if things do not work out, it is probably easier for a private company with substantial investment banker ownership to renegotiate its debts.

Many recent examples attest to the enormous gains to be made by organizers of leveraged buyouts. We have already mentioned the Norris example, in which assets bought for 1.6 times book were resold to the public for 7 times book value less than two years later. Two other striking examples are Converse and Gibson Greeting Cards. While these were "leveraged buyouts," they could not strictly be called "management buyouts" since both companies were purchased as divisions of public companies (Allied and RCA, respectively). Yet the huge profits made (returns to organizers were 5 to 1 in Converse and 200 to 1 in the Gibson case) were also likely to have been due in part to value transferred from public shareholders.
Just as exogenous circumstances brought on the MBOs in the early 1980s, exogenous circumstances also blessed them two years later. The new issues market has been especially hot, enabling MBO organizers who bought assets in the bear market of the very early 1980s to do quite well. While there is good reason to believe that MBOs have done well in part because they encouraged efficiency and in part because of tax breaks, there was also clearly a large element of luck involved.

5.3 Conclusion

Whether or not management buyouts are a good thing depends on whom you ask. To the investment bankers who earned both high fees and 50–60 percent annualized returns on their equity positions, MBOs were a good thing. To the shareholders who got out of poorly performing firms at a 50 percent premium, MBOs were probably a good thing, although they may have wished that they could have stayed on to receive a bigger portion of the tax and efficiency gains and, with the benefit of hindsight, to profit from the enormous rally in the new issues market. MBOs were probably also a good thing for managers who traded a good deal of sweat for valuable equity positions, and perhaps more important, for the opportunity to escape a hostile takeover. To the banks, MBOs were probably also a good thing, in contrast to many of their other above prime loans. The principal loser in MBOs may very well be the taxman who definitely paid for at least some of the profits made by everybody else.

Whether MBOs are a good thing from the economist’s perspective depends on whether they promote economic efficiency. While it is likely that much of the premium and the impetus behind MBOs came from the existence of value transfer gains, the end result was clearly a nontrivial amount of value creation. The enterprises emerging from MBOs are invariably structured to give managers greater incentives to cut costs and to budget capital more responsibly. Increased management ownership, concentrated ownership in the hands of knowledgeable profit-motivated investment bankers, and reduced free cash flows all contribute to the value created in MBOs. Finally, managers who know their firms best get to keep them, and all of the upheaval costs associated with hostile
takeovers are avoided. While there is no doubt that issues of fairness to various parties loom large in any view of management buyouts, from the point of view of promoting efficiency they appear to be a good thing.

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