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Private Equity and Corporate Governance: Retrospect and Prospect

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ABSTRACT

Manuscript Type: Review
Research Question/Issue: We assess the corporate governance role and the impact of private equity.
Research Findings/Results: Private equity firms are heterogeneous in their characteristics and activities. Nevertheless, a corporate governance structure with private equity involvement provides incentives to reduce agency and free cash flow problems. Additionally, private equity enhances the efficacy of the market for corporate control. Private equity investment is associated with performance gains, with such gains not simply being a result of transfers from other stakeholders. In the short term, the benefits appear clear to outgoing owners and to the new owners and management while in the longer term the benefits are less clear. While non-financial stakeholders argue that other stakeholders suffer in the short and long term, the evidence to support this view is at best mixed.
Theoretical Implications: By reviewing a comprehensive selection of theoretical and empirical papers published in refereed academic journals in finance, economics, entrepreneurship, and management as well as publicly available working papers and private equity industry studies, we develop a more complete understanding of private equity investment. Agency theory has shortcomings when applied to the broad sweep of private equity-backed buyout types, as in some cases pre-ownership change agency problems were likely low (e.g., family firms), in some cases the exploitation of growth opportunities owes more to the entrepreneurial behavior of managers than to improved incentives, and in some institutional contexts outside Anglo-Saxon countries traditional agency issues are different and stakeholder interests are more important. There is a need for further theorizing on the heterogeneity of buyout and private equity types and the contexts in which they occur. Particularly useful perspectives seem to be entrepreneurial perspectives (e.g., entrepreneurial cognition, strategic entrepreneurship), stewardship theory, and institutional theory. Stakeholder governance theory (e.g., relating to employee ownership and participation) may also be useful for explaining wider distribution of gains.
Practical Implications: Private equity investment is a positive feature of the corporate restructuring landscape. There is a need for managers and their advisors to be aware of the heterogeneity of the opportunities to create value and the expertise of different private equity firms. Policymakers designing mechanisms to regulate private equity need to be aware of the systematic evidence that shows a more positive impact of private equity than some have claimed, but also that there are heterogeneous effects relating to different types of buyouts and private equity firms that need to be taken into account.

Keywords: Corporate Governance, Institutional Shareholders, Mergers and Acquisition, Financial Performance, Business Outcomes

INTRODUCTION

It is well documented that the separation of ownership from control and the dispersed ownership structure of the public corporation create agency costs that reduce shareholder wealth (Jensen and Meckling, 1976; Fama and Jensen, 1983; Hart, 1995). In his seminal paper, Jensen (1989) argues that the publicly held corporation has been eclipsed by a relatively new organizational structure in which equity is privately held with peak tier management having a significant equity stake, that the firm is highly leveraged, and that there is an "active investor" in the form of private equity (PE) institutions. These features of this organizational structure combine to create the necessary incentive and monitoring mechanisms to induce wealth maximization.

Private equity and buyout transactions have become an increasingly important governance mechanism to rapidly and radically restructure organizations worldwide (Wright, Robbie, Chiplin and Albrighton 2000b; Cumming, Siegel and Wright, 2007; Wright, Burrows, Ball, Scholes,

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TABLE 1
Value of Buyouts/Buy-ins (€m)

Country Name	1998	1999	2000	2001	2002	2003	2004	2005	2006
US	16633	20590	32308	18462	31538	72308	105385	152308	179231
Austria	95	680	734	47	154	303	110	287	41
Belgium	820	2595	342	1744	517	1448	2270	4257	588
Denmark	267	2520	1313	500	1391	848	260	7089	13369
Finland	560	1085	675	1047	480	1039	977	2163	881
France	6153	8387	6502	6387	15568	8767	11520	21623	23282
Germany	5230	4642	14879	7229	8252	11974	17915	12928	20622
Ireland	243	1475	259	5021	4930	747	977	773	1004
Italy	670	2997	2560	1107	3428	7773	2940	17527	6392
Netherlands	3397	2906	1856	4433	1899	4958	7614	10338	25782
Norway	22	225	1004	1370	142	308	431	470	1581
Portugal	84	206	83	2	26	54	8	76	94
Spain	854	1715	941	1532	2069	934	2279	9391	4100
Sweden	928	2686	3169	3005	1116	2226	1701	4702	5435
Switzerland	1347	1013	1772	715	2766	865	1584	1081	924
UK	23270	26869	38419	31346	24851	23574	30155	35411	38261
Australia	1293	3433	168	1315	553	478	752	1147	3911
Canada	598	30	2365	228	1979	916	2279	1704	2404
Japan	24	956	1074	1473	711	5121	4745	2734	24
S. Korea				769	491			673	1093

Source: CMBOR/Barclays Private Equity/Thomson Financial

Meuleman and Amess 2007b). The US buyout market emerged in the early 1980s and has since diffused worldwide (Table 1).

The period since 2000 saw a notable surge in deal activity internationally (Wright *et al.*, 2007b). For example, in addition to rapid growth in the US, the Western European market grew by more than 50 per cent in 2005 and rose further in 2006 to reach €160bn and the UK PE market rose some 70 per cent in value in 2007 (Table 1). Public to private (PTP) transactions were a particular feature of this explosion, with the PE-backed buyout of Alliance Boots in 2007 the first such deal involving a FTSE100 company and buyouts of listed corporations occurring in many European countries as well as in Japan for the first time (Wright *et al.*, 2007b).[1]

Growth in PE and the buyout market has been accompanied by increased media attention and criticism from, among others, trade unions and members of the European Parliament (PSE Group of the European Parliament, 2007). For example, John Monks, General Secretary of the European Trade Union Confederation, claims that "established companies (with consensual industrial relations systems) are destroyed" by PE firms who take them over (Monks, 2006). While industry studies have promoted the contribution of PE to economic and financial performance, PE firms have been accused of: (1) asset stripping and profiting from the reselling of assets within short periods of time (asset flipping); (2) instigating restructuring within firms that negatively impacts employment and employee remuneration; and (3) using leverage and off-shore holding companies to reduce tax charges and it is these that account for, or significantly contribute to, investment performance (PSE Group of the European Parliament, 2007).

Increased scrutiny of the industry in many countries has been accompanied by proposals to increase regulation of the industry (Treasury Select Committee, 2007; Unquote, 2008). Much of the criticism has been based on selective evidence and/or anecdotes (e.g., PSE Group of the European Parliament, 2007) and has generally ignored the large body of systematic research reaching back over two decades. Watt (2008) does, however, provide a recent exception from the trade union perspective.

There is therefore a strong need for a review of the role of PE in theory and of the available evidence on its impact. The outcome of such a review provides the basis for an assessment of the contribution of PE that has important implications for policymakers considering regulatory changes to the industry. Our review also leads us to identify a future research agenda that will enable further insights into the role of PE firms to be obtained.

Previous reviews have either focused on finance-related evidence from the first wave of PE and buyouts from the 1980s (e.g., Palepu, 1990; Jensen, 1993; Thompson and Wright, 1995) or, while dealing with the later period, sacrificed depth of focus on governance issues for breadth (Cumming *et al.*, 2007). We undertook a comprehensive selection of papers published in refereed academic journals in finance, economics, entrepreneurship, and management

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as well as publicly available working papers. We also include publications by the protagonists in the debate, particularly by the PE industry and trade unions.

We first outline why PE may be expected to bring benefits from a governance perspective. An agency perspective is most commonly employed; however, a distinguishing feature of this review is that we also include an entrepreneurial perspectives. PE also raises new issues about the role of the market for corporate control as a governance device in the context of PTP transactions, notably in terms of non-disciplinary mechanisms that are complementary to internal governance (Weir and Wright, 2006), and the role of private sales and bargaining processes that contrast with the traditional public takeover process; irrevocable commitments by existing shareholders are a particularly important part of this process (Wright, Weir and Burrows, 2007a).

Second, in terms of retrospect, we review empirical evidence relating to what we know about the impact of PE. We incorporate studies relating to governance aspects from different areas of literature that are often treated separately. The bulk of the evidence comes from the finance literature, although there is also an important stream of studies in the management and entrepreneurship literature. In terms of prospect, we discuss areas where we need to know more for both research and policy perspectives, and the methodological challenges involved.

ROLE AND NATURE OF PE

In this section we address two fundamental questions that concern PE. First, what problems does PE resolve; second, should we regard PE as a homogeneous concept? Responding to the first question, we will show how the involvement of PE has resulted in a number of organizational advantages, including addressing incentive alignment problems, addressing free cash flow (FCF) problems, augmenting the market for corporate control, and other benefits. In answering the second question, we will illustrate the variety of forms that PE can take, both within a country and between countries, and hence its flexibility as a means of bringing about organizational change.

Role of PE Providers

In traditional models, firms gain access to capital via public capital markets or from managers, family members, or friends. The latter group tends to be private, or unquoted, companies. PE firms represent an innovation in the capital market. They are concerned with investment in unquoted companies and create distinctive governance features. PE firms are involved in two main areas of activity – the provision of early stage venture capital and the provision of equity capital for buyouts. Buyouts are the principal focus of PE investments. PE investors, and often a management team, pool their own money (together with debt finance) to buy shares in a company from its current owners. Such transactions are called Leverage Buyouts (LBOs). The debt is usually provided by institutions, such as commercial banks, investment banks, and hedge funds. In larger transactions, the PE firm is likely to be the majority equity holder.

The equity funding for the deal will normally be provided by a PE fund. In the US and UK, the fund is usually set up as a limited partnership. Fund members may include pension funds, investment banks, insurance companies, wealthy individuals, and the fund's managers. By contributing a portion of the fund's investment in a specific buyout, fund members diversify their risk. PE therefore attracts new sources of funds because the fund spreads the risk rather than concentrating it in a small number of investors. The fund will have an exit strategy with the aim of maximizing returns in terms of fees and dividends received, but the main source of return will be the exit value generated.

Exit tends to take place 3–5 years after the buyout (Wright *et al.*, 2007b). PE therefore brings access to funds that would not otherwise have been available. In addition, exit occurs in a variety of ways, e.g., trade sales, flotation via an Initial Public Offering (IPO), or re-IPO if the buyout took a publicly quoted firm private, a secondary buyout, a leveraged recapitalization, or bankruptcy. With the exception of the last mentioned, each represents a business opportunity that may not have presented itself without initial PE involvement.

The above discusses what PE providers do but it does not explain why PE finance is necessary if firms can raise capital by other means. Arguments for PE involvement focus on the superiority of the post-buyout governance structure in attenuating agency problems compared with the public corporation in particular rather than as a source of finance per se. Agency theory identifies a number of important governance characteristics that provide antecedent arguments for buyouts in general and PTP transactions in particular.

Private Equity and Incentive Alignment. The corporate governance problem is concerned with creating incentive and control devices to ensure managers use firms' resources in the interests of their owners and pursue value maximization. The diffuse ownership structure of the public corporation, while allowing risk to be efficiently allocated, is not conducive to the effective monitoring of managers, because free-riding can occur (Jensen and Meckling, 1976; Fama and Jensen, 1983; Hart 1995; Thompson and Wright, 1995). The incentive realignment hypothesis posits that the reunification of ownership and control in the post-buyout firm will improve managerial incentives.

Evidence indicates firms involved in PTP LBOs have significantly higher managerial share ownership than those involved in traditional acquisitions of listed corporations (Maupin, 1987; Halpern, Kieschnick and Rotenberg, 1999). In addition, firms going private had higher board and CEO ownership than firms remaining public (Weir, Laing and Wright, 2005a), but that PE firms were more likely to be involved when board ownership was lower (Weir, Wright and Scholes, 2008a).

While these arguments have focused on PTPs, they are easily extended to divisions of large, diversified organizations. Where the diversified corporation's existing governance structure truncates divisional managerial incentives and rewards, the opportunity for upside gains from a buyout may exist (Wright, Thompson, Chiplin and Robbie, 1991). In multidivisional organizations investment funds may not be allocated to divisions on the basis of rates of

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return but as a result of internal power dynamics (Wright and Thompson, 1987). Also, where divisions are peripheral to the core activities of a parent company, managers might face investment restrictions from headquarters (Wright, Hoskisson and Busenitz, 2001). These problems may be eased after the buyout as the PE provider becomes an "active investor" seeking profitable innovation and business development. A buyout creates entrepreneurial incentives and discretionary power for the new management team to decide what is best for the business (Wright, Hoskisson and Busenitz, 2000a; Wright *et al.*, 2001).

Within a strategic entrepreneurship perspective, PE firms may provide complementary resources and capabilities that may be missing from the management team and some PE firms may be much more skilled in how they implement monitoring and advisory devices as they are more effective at learning from experience to create distinctive organizational capabilities (Barney, Wright and Ketchen, 2001; De Clercq and Dimov, 2008). The scope for making these improvements may be greater in divisional buyouts than in buyouts involving family and in secondary buyouts (Meuleman, Amess, Wright and Scholes, 2009).

Similarly, secondary buyouts provide a means to continue the buyout organizational form, albeit with a different set of investors. In contrast to managers in divisions of larger corporations, increased managerial equity stakes, and loosened controls by PE firms, or the introduction of more skilled PE firms, may facilitate improved performance through pursuit of growth opportunities.

In private and family firms, there is typically no separation of ownership and control prior to the buyout (Howorth, Westhead and Wright, 2004), and hence there is less scope for improvements from improved control mechanisms (Chrisman, Chua and Litz, 2004). In family firms, owner-managers with substantial equity stakes have incentives to seek out profitable opportunities and, as peak-tier coordinators, have the flexibility to implement new opportunities they identify (Howorth *et al.*, 2004). The prospects for gains arising from resolving any agency problems may be limited to those cases where ownership was dispersed before the buyout (Schulze, Lubatkin, Dino and Buchholtz, 2001; Howorth *et al.*, 2004). Therefore, PE may have less of a role to play in terms of resolving agency issues for private and family firms.

Addressing agency problems has implications for two principal aspects of managers' behavior – FCF and diversification. We consider each in turn. FCF is cash flow in excess of that required to fund projects with a positive net present value (NPV). FCF is most likely to be found in mature, cash rich firms with few growth options. Where there are agency problems, non-equity owning managers have an incentive to use FCF either to expand the firm beyond its optimal size from a value maximization perspective by investing in negative NPV projects or to build cash balances that remain unused.

Given that buyouts are funded mainly by debt, the introduction of leverage as a substitute for equity in a buyout commits management to pay out future FCFs in servicing the debt rather than investing in sub-optimal projects. Management gain from the incentive to perform well both from receiving a significant equity stake and from the increased risk of default should they fail to service the debt and/or break debt covenants (Jensen, 1986).[2]

The evidence relating to FCF is, at best, mixed. With respect to the first wave of PE buyouts, Lehn and Poulsen (1989) found that firms going private had higher FCFs than firms that remained quoted. However, other evidence suggests that FCF has no impact on the decision to go private (Opler and Titman, 1993; Halpern *et al.*, 1999; Weir *et al.*, 2005a).

Renneboog, Simons and Wright (2007) considering the second PE wave from the late 1990s find that incentive realignment is one of the main sources of shareholder gains on the announcement of a PTP. They find no support for the FCF argument. In addition, Weir, Laing and Wright (2005b) also find that an expected reduction of FCF does not determine the premiums.

The second aspect concerns overdiversification. Theory and evidence suggest that overdiversified firms underperform, particularly when the assets held within one firm are not complementary (Palich, Cardinal and Miller, 2000). Overdiversification and subsequent underperformance is a consequence of weak corporate governance. A distinguishing feature of LBOs financed by PE is that PE firms choose LBO targets that have separable assets and businesses that can be sold (Seth and Easterwood, 1993). Consequently, PE firms, by targeting over diversified firms with separable assets that can be divested, are targeting firms with weak corporate governance.[3]

Private Equity and Augmentation of the Market for Corporate Control. The PTPs might be a defensive measure against a hostile takeover bid. The argument that going private is a response to the threat of hostile takeover has implications for the governance structures of firms as it implies that the threat is a substitute for ineffective boards. The threat of a hostile, disciplinary takeover substitutes for weak governance and poor incentive alignment (Jensen, 1986; Lehn and Poulsen, 1989).

The evidence on this issue is mixed. Early US evidence suggests management buyouts (MBOs) experienced significantly more takeover pressure prior to the MBO (Singh, 1990; Halpern *et al.*, 1999). However, more recently both Weir *et al.* (2005b) and Renneboog *et al.* (2007) find that a defensive reaction against a takeover was not a significant explanation for UK PTPs.

Effects of Corporate Governance Regulations. Following the introduction of corporate governance regulations requiring significant non-executive director representation, as in the UK's Combined Code of Best Practice (1998, 2003), firms going private would be expected to be less likely to adopt the Code's recommended governance structures. This means that they would have fewer non-executive directors and more duality than firms subject to traditional acquisitions by existing listed corporations.

Evidence from UK PTPs shows that before they go private, these corporations do indeed tend to separate the functions of CEO and Chair of the board less often than matched firms remaining public (Weir *et al.*, 2005a) and tra-

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ditional acquisitions of corporations (Weir and Wright, 2006). UK PTPs have lower valuations than traditional acquisitions of listed corporations by other corporations, indicating managerial private information, and greater board ownership suggesting that outside bidders have been deterred from bidding for the firms because of the potential difficulties involved in dealing with significant board ownership. Australian PTP evidence, in some contrast, indicates that insider ownership is not significantly higher in PTPs than for traditional acquisitions of listed corporations (Evans, Poa and Rath, 2005). Cornelli and Karakas (2008) find no significant change in board size from pre- to post-PTP. Board representation by PE firms changes according to PE firm style and anticipated challenges of the investment.

Adoption of the recommendations of the Combined Code (2003) in the UK has coincided with an increase in both friendly takeovers and PTPs, suggesting that the market for corporate control and internal governance mechanisms are complements rather than substitutes as indicated by the higher board ownership and duality of CEO and Chair in UK PTPs, but not lower proportions of outside directors and pressure from the market for corporate control (Weir and Wright, 2006).

Recent research relating to the market for corporate control in general has drawn attention to the role of private sales and bargaining processes that contrast with the traditional public takeover process (Boone and Mulherin, 2002). Irrevocable commitments by existing shareholders are used extensively in PTP transactions, reducing the costs associated with a failed bid (Wright *et al.*, 2007a). The initial commitment ensures that, without any higher alternative bid, the agreement to sell the shares becomes binding. PE firms can improve the chances of success in negotiating a buyout of a listed corporation by seeking irrevocable commitments from significant share-holders to accept the bidder's bid before the offer is made public. The announcement of substantial irrevocable commitments may make other potential bidders less likely to enter the contest with an alternative bid. Gaining these commitments by reputable PE firms sends a signal to other non-committed shareholders that the deal is an attractive one.

Managers of listed corporations with a significant equity stake may be able to resist hostile pressure for takeover by another corporation. These businesses may be attractive PTP candidates, however, as the PE firms will likely seek to provide financial support for profitable entrepreneurial initiatives from management and also have the specialist expertise and contractual mechanisms to monitor and add value to them (Wright and Robbie, 1998). This might be attractive to managers unable to realize business opportunities if there are financial constraints.

The Nature of PE Models

Private equity is a term that can be applied to many situations and frameworks. These differences can be explained in terms of the different types of buyout, the stage of involvement, and how roles differ between countries.

Heterogeneity of Buyout Types. PE provides finance for a range of buyout types. LBOs can be broadly divided into insider-driven deals (i.e., MBOs) and outsider-driven deals (i.e., management buy-ins (MBIs) and investor led buyouts). The buyout sector covers a number of other different vendor sources of deal – PTP transaction that occurs when a quoted firm is taken private, with or without the existing management, buyouts of divisions, secondary buyouts, buyouts of family firms, buyouts of public sector firms, and buyouts of firms in bankruptcy (Figure 1) (Wright *et al.*, 2007b). Recognition of this heterogeneity is important in understanding the impact of the governance aspects of PE and buyouts. In this article, we consider all forms of PE-backed buyouts.

Heterogeneity of PE Types. There are two main forms of PE involvement. The first is most closely associated with the US where PE often takes the form of venture capitalists that are involved in early stage business development. It is also often associated with high risk sectors, such as biotechnology. Venture capitalists also operate in the UK but are of less importance. In general, these early stage deals make little if any use of debt as the portfolio companies are likely to generate little revenues and also need to retain cash within the business to fund growth. The second main type of PE activity, which is the focus of this review, is buyout activities involving in buyouts of later stage, mature businesses. However, the fact that we can identify two streams of activity illustrates that PE is not a homogeneous concept.

In many regions of the world a variety of types of PE firm are to be found with different investment time horizons and different objectives, e.g., public sector PE firms, sovereign wealth funds, and captive PE firms that are part of banks and insurance corporations.

As noted above, PE buyouts involve a complementary combination of equity and leverage. But variations in the types of equity and debt instruments available allow for different approaches to governance in deals. Some PE firms may make use of extensive performance contingent remuneration contracts in relation to management's equity stakes, while others eschew such variable approaches. Leverage used may also take different forms, with associated different governance elements. For example, deals with standard secured repayment loans with accompanying covenants provide for both early warning signals of impending problems while allowing for flexibility in the application of covenants (Citron, Robbie and Wright, 1997; Citron, Wright, Rippington and Ball, 2003). On the other hand, debt in the form of quoted bonds may have fewer covenants but allow for less flexible renegotiation if performance is below expectations. Whichever combinations of equity and debt instruments are used, it is important to ensure that the interests of PE firms and debt providers are aligned.

Heterogeneity of Institutional Contexts. PE is becoming more international, as shown in Table 1, yet there remain major differences in its penetration between countries. Space constraints preclude detailed treatment here, but three main factors influence the development of a PE market: the gen-

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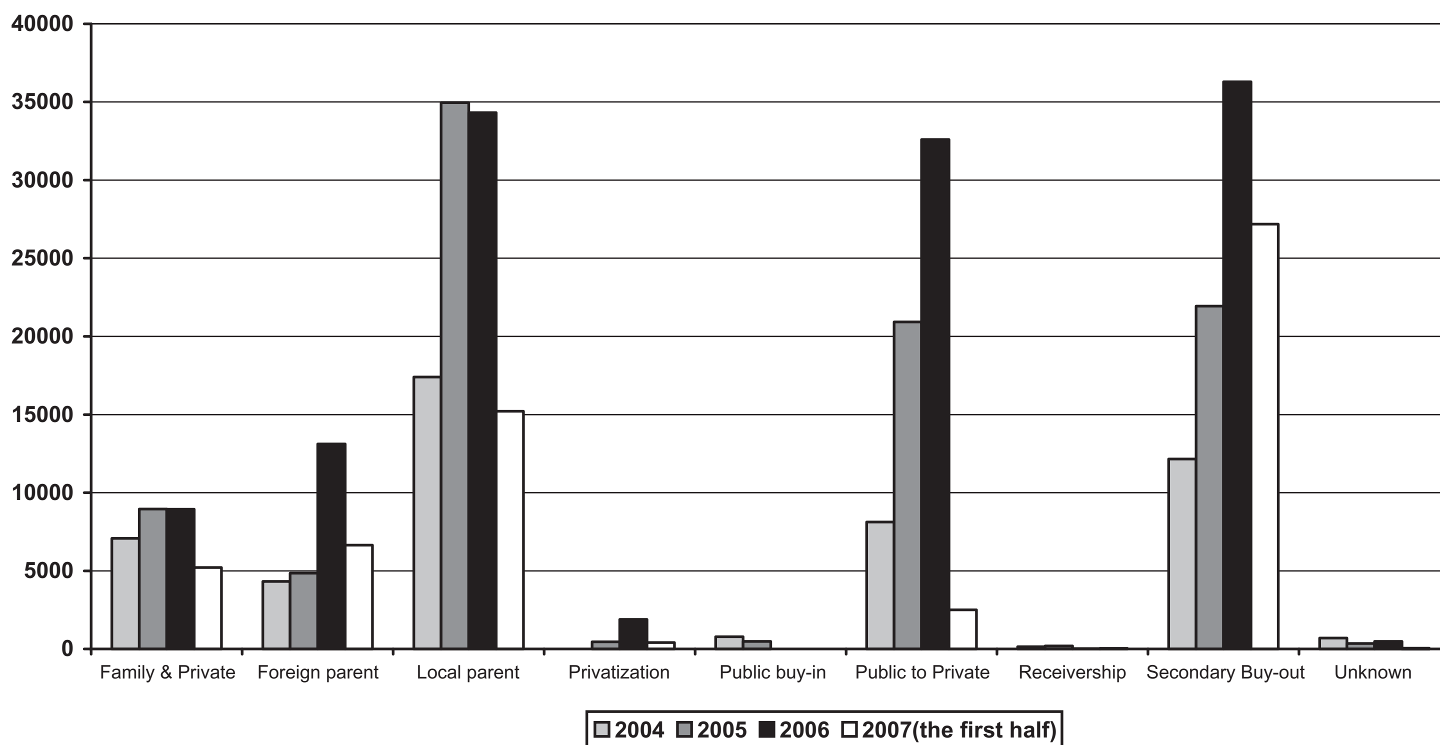
FIGURE 1
Vendor Sources of Buyouts in Europe



eration of deal opportunities, which is likely heavily influenced by both the supply of deal flow from different vendor sources and the demand for PE in terms of the willingness of managers to take risks and their willingness to buy enterprises; the infrastructure to complete transactions, including sources of equity and debt funding, the nature of legal and taxation regimes, including corporate reporting regimes, and the existence of advisors who can both identify and negotiate buyouts; the existence of suitable exit routes comprises the availability of stock markets, mergers, and acquisitions markets and the scope for recapitalizations through secondary buyouts (Wright, Thompson and Robbie, 1992; Wright, Kitamura and Hoskisson, 2003).

In the US and UK, the markets were stimulated by a strong supply of opportunities to restructure diversified groups and listed corporations. In contrast, in Germany for example, the need to deal with succession problems in family-owned firms was relatively more important, but there was traditionally a reluctance to sell to PE firms partly because of the strong relationship with banks and partly because of negative perceptions about PE firms (Achleitner, Nathusius, Herman and Lerner, 2008). The need to restructure large corporations as a result of increased global competition has created pressures that are leading to an increase in PE deals.

Attitudes towards entrepreneurial risk and the willingness of management to undertake a buyout were noticeably more positive in the UK and US than in most other European countries and Japan, but some change in attitudes there have been noted (Wright *et al.*, 2003).

The US and UK have more developed PE and debt markets, better intermediary networks, and more favorable legal and taxation frameworks than in continental Europe (EVCA, 2008). Yet because of the perceived need for restructuring, changes are underway to make this infrastructure more favourable in other countries. The sources of PE funding for buyouts are also different between countries, with pension funds being more important in the UK, but in Germany and Japan the main source of funds is the banking system. There are notable differences in the role of stock and acquisitions markets to facilitate the realization of investments. Acquisition markets are especially important for PE buyouts as they tend to have slower growth than early stage deals, while the ability to achieve a secondary buyout may be useful in an environment of relatively weak stock and corporate acquisition markets.

Conditions that have meant that some institutional contexts have been resistant to PE transactions are now changing. For example, in Japan pressure from global competition, pressure from global shareholders, and an excessive debt burden produced consolidation within and between *keiretsus* and the divestment of inefficient subsidiaries as PE deals, alongside a change in the attitude of corporate managers to such transactions in the face of loss of traditional life-time employment (Wright *et al.*, 2003). For example, Nissan Motor, part of the Mizuho Group sold many non-core assets as buyouts, including its Vantec distribution business.

Although PE has grown in Continental Europe, recent developments have reinforced the negative perception in

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some corners about implications of PE for the European Social Model, leading to calls for major tightening of regulation (e.g., PSE Group in European Parliament, 2007). This raises important questions about whether the governance role and impact of PE depends on the particular institutional context in line with the varieties of capitalism perspective (Hall and Soskice, 2001).

Therefore, PE has been shown to be a solution to agency issues given the new financial structure under which the equity is owned by the PE and the management and the increase in debt, which increases monitoring. It has also been shown to adapt to different international institutional contexts. PE draws on different sources of equity funding and it has been shown that it is an important means of funding firms with different growth opportunities. Therefore, although PE is an alternative source of funding, it can be applied in a range of different international contexts and in a variety of industries.

RETROSPECT: THE CONSEQUENCES OF PE

A key argument above was that PE firms have a positive role to play in addressing the agency problems associated with the separation of ownership and control, resulting in the realignment of managerial incentives towards value maximization. From this agency perspective, it therefore follows that firms subject to a PE-backed buyout will be expected to demonstrate superior performance compared with other organizational structures.

This section examines the evidence in relation first to the extent and nature of the impact of PE and buyouts on firm performance. We then consider the extent to which these effects relate to active monitoring by PE firms and other related governance mechanisms or whether they arise from transfers from other stakeholders. This is followed by discussion of how long the impact of PE buyouts persists. In light of our discussion that there may be more than one PE model, we examine whether there are differences between institutional contexts. The samples used, periods covered, and main findings of academic studies are summarized in Table 2.

Impact of PE and Buyouts on Performance

There is now a substantial body of literature going back to the 1980s concerning the performance effects of buyouts and recent detailed reviews are available in Cumming *et al.* (2007) and Kaplan and Stromberg (2009). As the main focus of this review is on the role of governance in PE and buyouts, we provide an overview here of the principal performance findings.

Empirical evidence concerning the performance of buyouts has used a variety of performance indicators. The performance indicators can be broadly classified into: accounting measures (e.g., profitability ratios), stock-based measures, and economic measures seeking to capture factor utilization. A consistent feature of the post-buyout performance literature is that performance gains are reported both by industry studies (e.g., EVCA, 2001; Constantin Associes and AFIC, 2007; BVCA, 2008) and academic research, by whatever measure of performance is employed, e.g., the share price studies of DeAngelo, DeAngelo and Rice (1984), Kaplan (1989a), Lehn and Poulsen (1989) and Marais Schipper, and Smith (1989); the accounting data studies of Kaplan (1989a), Smith (1990), and Smart and Waldfogel (1994); and factor productivity studies of Lichtenberg and Siegel (1990), Wright, Wilson and Robbie (1996b), Amess (2002; 2003), and Harris, Siegel and Wright (2005). Thus, there is scant debate regarding the performance consequences of buyouts, at least concerning short-term effects.

While these studies examined buyout performance from a variety of vendor types, this aspect was often not explicitly addressed within the studies. Some of the more recent literature does address this. Desbrières and Schatt (2002) find that performance gains are especially strong for PTPs and divisional buyouts, but less so for buyouts of family firms, and Meuleman *et al.* (2009) report that divisional buyouts have significantly greater growth than family or secondary buyouts. There are still the critical questions surrounding how the reported improvements in factor utilization are achieved. Are studies measuring factor utilization capturing increases in output for a given set of inputs? Are such studies capturing a reduction in the factors of production used to produce a given output? We return to this point below when we consider effects on employment.

The PTP buyouts in both the first and second waves particularly seem to achieve performance improvements through strategies of cost and capital expenditure reductions and refocusing through divestment of unwanted parts (Liebeskind, Wiersema and Hansen, 1992; Long and Ravenscraft, 1993; Seth and Easterwood, 1993; Smart and Waldfogel, 1994; Wiersema and Liebeskind, 1995; Weir *et al.*, 2008a; Weir, Jones and Wright, 2008b).

It is often overlooked, however, that evidence from divisional and family firm buyouts especially shows significant increases in corporate entrepreneurship, including new product development, better use of research and development, and increased patent citations, (Bull, 1989; Green, 1992; Wright *et al.*, 1992; Zahra, 1995; Lerner, Strömberg, and Sørensen, 2008). For example, the budget hotel chain Travelodge, a divestment from Compass, was sold in 2006 after 3 years of PE ownership. Although under PE ownership, the company engaged in sale and leasebacks, divestment of unwanted divisions and efficiencies in room cleaning times, it also embarked on a major expansion program involving building the brand and opening more hotel rooms than any other UK operator in this period (Harrington, 2006).

Performance Gains, Active Monitoring, and Other Governance Mechanisms

Buyouts are typically characterized by active monitoring by PE investors, high leverage, and the concentration of equity under management control. It is this combination of characteristics that creates a unique corporate governance structure. Both UK and US evidence suggests that the most important governance characteristic is the management equity stake (Malone, 1989; Thompson *et al.*, 1992; Phan and

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TABLE 2
Chronological Summary of Academic PE and Buyout Studies Reviewed

Authors	Country	Nature of Transactions	Findings
DeAngelo *et al.* (1984)	US	PTPs	Average premiums of 56 per cent in PTPs and 22 per cent cumulative average abnormal return on bid announcement day.
Lowenstein (1985)	US	PTPs	Large financial gains not the same as real gains and many are tax generated; need for mandated auctions.
Maupin (1987)	US	PTP MBOs	Ownership concentration, price/book value ratio, cash flow to net worth, cash flow to assets, P/É ratio, dividend yield, and book value of assets to original costs distinguish PTPs from comparable non-PTPs
Chen and Kensinger (1988)	US	Defensive ESOP buyouts	Performance of defensive ESOPs below that of LBOs.
Bull (1989)	US	MBOs, LBOs	Evidence of both cost reduction. but greater managerial alertness to opportunities for wealth creation more important.
Malone (1989)	US	Smaller PE-backed LBOs	Management equity stake important driver of post buyout changes.
Amihud (1989)	US	PTPs	PTPs generate average 43 per cent premiums; mandating bidder auctions would deter bids occurring at all.
Marais *et al.* (1989)	US	LBOs	No evidence of wealth transfer from pre-buyout bondholders.
Kaplan (1989a)	US	LBOs	Profits and cash flows increase post buyout; operating income/assets up to 36 per cent higher for LBOs compared with industry median.
Kaplan (1989b)	US	LBOs	Tax savings account for small fraction of value gains in LBOs; significant correlation between estimated tax savings and buyout bid premium.
Lehn and Poulsen (1989)	US	PTPs	Significant relationship between undistributed cash flows and decision to go private; premiums paid significantly related to undistributed cash flows; results strongest for cases where management had lower pre-buyout equity.
Lichtenberg and Siegel (1990)	US	Plant	LBOs typically in low R&D industries. R&D fall both pre and post buyout not statistically significant; R&D fall may be accounted for by divestment of more R&D-intensive divisions; Decline in relative compensation of non-production workers.
Singh (1990)	US	PTP MBOs, LBOs	Prior takeover attempt, cash flow to sales and net assets to receivables predict likelihood of buyout.
Smith (1990)	US	MBOs	Up to 6 per cent and 3 per cent increase in industry-adjusted ratio of operating cash flows to operating assets and operating cash flows to employees, respectively. Adjustments in working capital contribute to improved performance but not job losses or reductions in expenditures for advertising, maintenance, R&D, property, plant, or equipment.
Kaplan (1991)	US	LBOs	Heterogeneous longevity. LBOs remain private for median 6.80 years. A total of 56 per cent still privately owned after year 7. LBOs funded by leading PE firms no more likely to stay private than other buy-outs; no difference in longevity of divisional or full LBOs.
Cook, Easterwood and Martin (1992)	US	LBOs	Bondholders with covenants offering low protection against corporate restructuring lose some percentage of their investment.
Denis and Denis (1992)	US	Leveraged recapitalizations and LBOs	Leveraged recapitalizations raise shareholder value but not as much as in LBOs.
Lee (1992)	US	MBOs, LBOs	Stock market response to depends on whether subsequent bid occurs.**
Opler (1992)	US	LBOs	11.60 per cent increase in industry-adjusted cash flow to sales ratio; 40.30 per cent increase in industry-adjusted operating profits per employee; capital expenditure, income tax, and research and development expenditure decline post-LBO.

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TABLE 2
Continued

Authors	Country	Nature of Transactions	Findings
Thompson, Wright and Robbie (1992)	UK	MBOs, MBIs returning to market	Management team equity stake by far larger impact on relative performance of returns to equity investors from buyout to exit than leverage, equity ratchets, etc.
Wright *et al.* (1992)	UK	MBOs, MBIs	68 per cent showed improvements in profitability; 17 per cent showed a fall; 43 per cent reduced debt days and 31 per cent increased creditor days; 18 per cent sold surplus land and buildings; 21 per cent sold surplus equipment; MBOs enhance new product development; 44 per cent acquired new equipment and plant that would not otherwise have occurred.
Liebeskind *et al.* (1992)	US	LBOs	LBOs show significantly greater reduction in number of plants than control sample of matched public corporations and divested significantly more businesses in terms of mean employees, revenues and plants but not in terms of median revenue and plants; LBO managers downsized more lines of businesses than in the control group.
Green (1992)	UK	MBOs	Buyout ownership allowed managers to perform tasks more effectively through greater independence to take decisions. Managers had sought to take entrepreneurial actions prior to buyout but had been prevented from doing so because of the constraints imposed by parent's control.
Seth and Easterwood (1993)	US	Large LBOs	5/32 firms were complete bust-ups, all involving buyout [PE] specialists; 14/32 firms refocused by divesting unrelated lines; 21/32 firms engaged in business focus by divesting related lines and 9/32 in market focus; Buyouts focus strategic activities towards more related businesses.
Opler and Titman (1993)	US	PTPs	Free cash flow no impact on going private decision but distress costs important.
Frankfurter and Gunay (1992)	US	MBOs, LBOs	Significant gains from tax savings major driving force but real economic gains also expected.
Long and Ravenscraft (1993)	US	LBOs and MBOs	LBOs result in a Reduction in R&D Expenditure but LBOs typically in low R&D industries; R&D intensive buyouts outperform non-buyout industry peers and other buyouts without R&D expenditure.
Warga and Welch (1993)	US	LBOs	Bondholders with covenants offering low protection against corporate restructuring lose some percentage of their investment.
Wright, Robbie, Romanet, Thompson, Joachimsson, Bruining and Herst (1993)	UK, France, Sweden, Holland	MBOs	State of development of asset and stock markets, legal infrastructures affecting the nature of PE firms' structures and the differing roles and objectives of management and PE firms influence timing and nature of exits from buyouts.
Easterwood, Singer, Seth and Lang (1994)	US	PTPs	Existing owner returns greater with competing bids.
Smart and Waldfogel (1994)	US	LBOs	Median shock effect of buyout [correcting for forecast performance] of 30 per cent improvement in operating income/sales ratio between pre-LBO year and second post-LBO year.
Denis (1994)	US	LBO and Leveraged recapitalization	Gains in LBO greater than in leveraged recapitalization attributed to more important role of equity ownership and active investors in LBOs.
Wright, Robbie, Thompson and Starkey (1994b)	UK	MBOs	Heterogeneity of longevity influence by managerial objectives, fund characteristics and market characteristics; Larger buy-outs and divisional buy-outs significantly more likely to exit more quickly.
Wright, Thompson, Robbie and Wong (1995)	UK	MBOs, MBIs	Heterogeneous longevity. Greatest exit rate in years 3–5; 71 per cent still privately owned after year 7. MBIs greater rate of exit than MBOs in short term consistent with higher failure rate of MBIs. Exit rate influenced by year of deal [economic conditions]. To achieve timely exit, PE firms are more likely to engage in closer (hands-on) monitoring and to use exit-related equity-ratchets on management's equity stakes.

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TABLE 2
Continued

Authors	Country	Nature of Transactions	Findings
Phan and Hill (1995)	US	LBOs of listed corporations	Managerial equity stakes had a much stronger effect on performance than debt levels for periods of three and five years following the buyout.
Wiersema and Liebeskind (1995)	US	Large LBOs	Large LBOs reduce lines of business and diversification.
Zahra (1995)	US	MBOs	MBOs result in more effective use of R&D expenditure and new product development.
Holthausen and Larcker (1996)	US	Reverse LBOs	Leverage and management equity falls in reverse buyouts but remain high relative to comparable listed corporations that have not undergone a buyout. Pre-IPO accounting performance significantly higher than the median for the buyouts' sector. Following IPO, accounting performance remains significantly above the firms' sector for four years but declines during this period. Change is positively related to changes in insider ownership but not to leverage.
Wright, Wilson, Robbie and Ennew (1996a)	UK	Failed and non-failed MBOs	MBOs with high leverage, lower net worth, lower labor productivity more likely to fail.
Wright *et al.* (1996b)	UK	MBOs	Profitability Higher for MBOs than comparable non-MBOs for up to 5 years.
Halpern *et al.* (1999)	US	PTPs	Comparing LBOs and traditional acquisitions, LBOs more likely with higher managerial ownership and takeover threat but not related to lower growth prospects or higher free cash flow.
Cotter and Peck (2001)	US	LBOs	Active monitoring by a buyout specialist substitutes for tighter debt terms in monitoring and motivating managers of LBOs. Buyout specialists that control a majority of the post-LBO equity use less debt in transactions. Buyout specialists that closely monitor managers through stronger representation on the board also use less debt.
Bruton, Keels and Scifres (2002)	US		Agency cost problems did not reappear immediately following a reverse buyout but took several years to re-emerge.
Desbrières and Schatt (2002)	France	MBOs, MBIs	Accounting performance changes depend on vendor source of deal.
Amess (2002)	UK	MBOs	MBOs Enhance Productivity; marginal value added productivity of labor is significantly higher than in comparable non-buyouts.
Amess (2003)	UK	MBOs	MBOs have higher technical efficiency 2 years pre-MBO and lower technical efficiency 3 or more years before than comparable non-buyouts; MBOs have higher technical efficiency in each of 4 years after buyout but not beyond 4 years than comparable non-buyouts.
Kosedag and Lane (2002)	US	ReLBOs (secondary PTPs)	Free cash flow not important for second time PTP but tax savings are.
Weir *et al.* (2005b)	UK	MBO, MBIs Listed Corporations	Firms going private have higher CEO ownership, higher institutional blockholder ownership, more duality of CEO and Board Chair but no difference in outside directors or takeover threats compared with firms remaining listed.
Evans *et al.* (2005)	Australia	MBOs, Acquisitions of Listed Corporations	Firms going private have higher liquidity, lower growth rates, lower leverage pre-buyout, and lower R&D. FCF is not significantly different. Takeover threat less likely to be associated with going private.
Harris *et al.* (2005)	UK	Divisional and Full-Firm LBOs and MBOs of Public and Private Companies	Plants Involved in MBOs Are Less Productive Than Comparable Plants Before the Buyout; They Experience a Substantial Increase in Productivity After a Buyout; Plants Involved in an MBO Experience a Substantial Reduction in Employment.
Jelic, Saadouni, and Wright (2005)	UK	Reverse MBOs, MBIs	Private equity-backed MBOs more underpriced than MBOs without venture capital backing but perform better than their non-VC-backed counterparts in the long run. Reverse MBOs backed by more reputable VCs exit earlier and perform better than those backed by less prestigious VCs

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TABLE 2
Continued

Authors	Country	Nature of Transactions	Findings
Weir and Wright (2006)	UK	MBO, MBI, Acquisitions of listed corporations	Firms going private have higher CEO ownership, higher institutional blockholder ownership, more duality of CEO, and Board Chair, but no difference in outside directors or takeover threats compared with firms subject to traditional takeovers.
Boulton, Lehn and Segal (2007)	US	Management and non-management led PTPs	Firms going private under-performed, but had more cash assets than industry peers, and had higher relative costs of compliance with Sarbanes-Oxley.
Renneboog *et al.* (2007)	UK	PTPs	Pre-transaction shareholders receive average 40 per cent premium share price reaction to the PTP announcement is about 30 per cent in 1997–2003 UK deals. Main sources of shareholder wealth gains are undervaluation of pre-transaction target, increased interest tax shields, and incentive realignment. Expected reduction of free cash flows does not determine the premiums; PTPs not a defensive reaction against a takeover.
Wright *et al.* (2007a)	UK	PTPs	PE firms proposing a PTP MBO more likely to gain the backing of other shareholders the greater the bid premium and the more likely the PE backer is to be reputable.
Amess and Wright (2007a)	UK	MBOs and MBIs	Employment growth is .51 of a percentage point higher for MBOs after the change in ownership and .81 of a percentage point lower for MBIs; Average wages in both MBOs and MBIs are lower than their non-buyout industry counterparts.
Amess and Wright (2007b)	UK	MBOs, MBIs, PE and non-PE-backed	After controlling for endogeneity in selection of buyouts, difference between employment effects of PE versus non-PE-backed buyouts not significant.
Cao and Lemer (2007)	US	Reverse LBOs	For a sample of 526 RLBOs between 1981 and 2003, three- and five-year stock performance appears to be as good as or better than other IPOs and the stock market as a whole, depending on the specification. There is evidence of a deterioration of returns over time.
Nikoskelainen and Wright (2007)	UK	MBOs	Private eeturns to investors enhanced by context-dependent corporate governance mechanisms.
Cressy, Munari and Malipero (2007)	UK	MBOs, MBIs	Operating profitability of PE-backed buyouts greater than for comparable non-buyouts by 4.50 per cent over first three buyout years. Industry specialization, but not buyout stage specialization, of PE firm adds significantly to increase in operating profitability of PE-backed buyouts over first three buyout years.
Guo, Hotchkiss and Song (2007)	US	PTPs	Returns to pre- or post-buyout capital significantly positive except for firms ending in distressed restructuring. Returns to post-buyout capital greater when deal financed with a greater proportion of bank financing, or when there is more than one PE sponsor.
Gottschalg and Wright (2008)	US	PE-backed LBOs	Rates of return on investees increases with: a convex (u-shaped) relationship with experience the PE firm has with PE investing; fewer deals done in parallel and hence the more strategic involvement by the PE firm; and greater expertise of the PE firm. Sector focus of PE firm does not play role in investee value creation/rate of return.
Acharya, Hahn and Kehoe (2009)	UK	PE-backed LBOs	High levels of PE firm interaction with executives during the initial 100-day value creation plan, creating an active board, significant replacement of CEOs and CFOs either at the time of the deal or afterwards and leveraging of external support important governance actions; the last two actions were especially related to investee out-performance.
Davis, Lerner, Haltiwanger, Miranda and Jarmin (2008)	US	Matched PE-backed and non-PE-backed firms & establishments	Employment grows more slowly in PE cases than in control pre-buyout and declines more rapidly post-buyout, but in 4–5th year employment mirrors control group; buyouts create similar amounts of jobs to control and more Greenfield jobs.

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TABLE 2
Continued

Authors	Country	Nature of Transactions	Findings
Amess, Girma and Wright (2008)	UK	LBOs, MBOs, MBIs, acquisitions, PE and non-PE-backed	PE-backed LBOs have no significant effect on employment. Both non-PE-backed LBOs and acquisitions have negative employment consequences; Employees gain higher wages after acquisitions, but lower after LBO.
Bacon, Wright, Demina, Bruining and Boselie (2008)	UK, Holland	MBOs, MBIs, PE and non-PE-backed	Insider buyouts show greater increase in high commitment practices; buyouts backed by private equity firms report fewer increases in high commitment management practices.
Cornelli and Karakas (2008)	UK	All PTPs	No significant change in board size from pre to post PTP. Board representation by PE firms changes according to PE firm style and anticipated challenges of the investment; per cent of PE firms on boards decreases slightly after exit.
Lerner *et al.* (2008)	Worldwide	PE-backed buyouts	Buyouts increase patent citations after PE investment, but quantity of patenting unchanged, maintain comparable levels of cutting edge research, patent portfolios become more focused after PE investment.
Weir *et al.* (2008b)	UK	PTPs	Performance deteriorates relative to the pre-buyout situation, but firms do not perform worse than firms that remain public and there some evidence that performance improves; PE-backed deals have a negative effect on profitability relative to pre-buyout; PE-backed deals performed better than the industry average, experienced job losses in the years immediately after going private, but employment increased subsequently, non-PE-backed buyouts increased employment after the first year post-deal, expenses lower after going private and profit per employee higher, z-scores improved.
Meuleman *et al.* (2009)	UK	Divisional, family, and secondary buyouts	Private equity firms' experience significant driver of higher growth in divisional buyouts; PE experience important influence on growth, but not profitability or efficiency; Intensity of PE involvement associated with higher profitability and growth.
Von Drathen and Faleiro (2008)	UK		For a sample of 128 LBO-backed IPOs and 1,121 non-LBO-backed IPOs during 1990–2006 LBO-backed IPOs outperform non-LBO-backed IPOs and a stock market index; percentage of equity retained by buyout group post offering drives outperformance.
Strömberg (2008)	Worldwide	PE-backed buyouts	58 per cent of deals exited more than 5 years after initial transaction; exits within 2 years account for 12 per cent and have been decreasing.
Bacon, Wright, Scholes and Meuleman (2009)	Pan-European	All PE-backed buyouts above Euros 5 m transaction value	Private equity firms adapt their approaches to different social models and traditional national industrial relations differences persist.

Key: ESOP buyout, Buyout with wider employee share ownership achieved through an Employee Stock Ownership Plan; IPO, Initial Public Offering; LBO, leveraged buyout; MBO, management buyout; MBI, management buy-in; PE, private equity; PTP, public to private transaction, i.e., taking private of a listed corporation; ReLBO, a secondary buyout, i.e., a buyout that is releveraged often with a new private equity investor; Reverse LBO (RLBO), a buyout that comes back to the stock market.

Hill, 1995). Note, however, recent evidence suggests that if management have a majority equity stake, this is related to negative performance (Nikoskelainen and Wright, 2007).

Active monitoring by PE investors and the characteristics of PE investors are still important characteristics in driving firm performance, however (Cotter and Peck, 2001; Guo *et al.*, 2007; Cornelli and Karakas, 2008). Indeed, the intensity of follow-up activity by PE firms is an important determinant of post-buyout performance. Industry studies show that PE firms provide both financial monitoring as well as strategic input (e.g., BVCA, 2008). Acharya *et al.* (2009) highlight the importance of high levels of PE firm interaction with executives during the initial 100-day value creation plan creating an active board, significant replacement of CEOs and CFOs either at the time of the deal or afterwards and leveraging of external support. Industry specialization of the PE firms also positively impacts on performance (Cressy *et al.*, 2007; Gottschalg and Wright, 2008). In contrast,

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the impact of PE firm experience is mixed with evidence suggesting that it has a positive impact (Gottschalg and Wright, 2008) and evidence of no impact (Meuleman *et al.*, 2009).

The importance of managerial ownership and active investors is highlighted in comparisons with leveraged recapitalizations, which effectively involve only the substitution of debt for equity in quoted companies (Denis and Denis, 1992) but which do not appear to have the same performance impact as LBOs (Denis, 1994). Similarly, defensive ESOPs, in which leveraged employee share purchases are used to forestall takeovers, do not appear to perform as well as LBOs (Chen and Kensinger, 1988).

Performance Gains and Transfers from Other Stakeholders

Transfers from Employees. Unions have recently generated a great deal of controversy around this issue with accusations that PE investors' wealth gains accrue from detrimental terms for employees. Unions argue that employees suffer via layoffs and lower wages (ITUC, 2007). For example, British trade unions highlighted workforce reductions at the AA auto breakdown and recovery service, while the chairman of the German Social Democratic Party cited the projected job losses in the buyout of Grohe as an example of PE locusts.

The counter-argument from practitioners is that in the creation of viable businesses, jobs are created (EVCA, 2001; Constantin Associes and AFIC, 2007; ASCRI, 2008; BVCA, 2008). Such has been the furor that this issue has received attention from policy makers, such as the UK Treasury Select Committee (2007) and the US Government Accountability Office (2008).

Yet the evidence adduced by critics is highly questionable as it has typically related to a small number of specific cases (PSE Group in European Parliament, 2007) that are not representative of the population of PE-backed buyouts (Bacon, Wright and Demina, 2004; Bacon *et al.*, 2008). Further, at least some of the specific cases cited would have either closed or experienced job losses without PE involvement, involved offsetting benefits, such as enhanced employee ownership (as in the AA, Work Foundation, 2007) and actually subsequently grew employment (as in the German firm Grohe [Milne, 2008]).

At the same time, industry studies, while usually involving representative surveys, have typically not involved direct comparisons with other non-buyout private companies. This is therefore an area where there has been a crucial need for systematic academic evidence. Academic studies generally show an initial reduction in employment followed by subsequent increases in employment (e.g., Smith, 1990), although the impact on employment has been more positive in respect of MBOs than in MBIs (Amess and Wright, 2007a).

However, much of the academic literature concerning the wage and employment consequences of LBOs has not distinguished between those buyouts with active PE involvement and those that do not have PE involvement. Davis *et al.* (2008) report that US evidence of PE-backed buyouts having lower employment growth both pre- and post-buyout. They do report, however, that PE-backed firms engage in more Greenfield job creation than other firms.

In contrast, Amess and Wright (2007b) and Amess *et al.* (2008) find that PE-backed buyouts do not have significantly different levels of employment compared with control firms, although specifically in the context of PTPs, Weir *et al.* (2008b) find reductions. In respect of wages, there does not appear to be a significantly different effect between buyouts and control sample firms (Amess *et al.*, 2008).

Transfers from Existing Shareholders Because of Exploitation of Inside Information. This is only an issue for insider-led buyouts, such as the MBO. The concern relates to incumbent managers having a dual role in the buyout process. There is a conflict of interest between management's fiduciary duty to negotiate the highest possible price for the current owners while also being members of a buyout team that wants to pay the lowest possible price for the firm (Bruner and Paine, 1988). It seems reasonable to suggest that managers will only participate in an MBO if it is financially advantageous to do so. This could arise if a firm is currently under-valued, which could arise if managers are understating current earnings or managers possess inside information about future earnings. DeAngelo (1986) finds no evidence of earnings being understated and suggests this is because public stockholders scrutinize financial statements in order to prevent such manipulation. Moreover, management will employ an independent investment bank to evaluate the offer terms.

A strand of this literature has examined abandoned buyouts in order to ascertain whether management has exploited inside information. If managers propose a buyout only when they have inside information, the act of management making an offer will reveal the presence of inside information. This will have a positive effect on the target's stock price, which should persist whether the buyout is completed or not since the presence of inside information has now been revealed. There is no evidence to support this argument with positive stock price returns only occurring in completed buyouts (Smith, 1990; Lee, 1992).

However, pre-buyout shareholders get a higher price for their stock if outside acquirers compete for control with the proposed MBO (Easterwood *et al.*, 1994). Moreover, this is the most successful method of obtaining a high valuation for stock compared with stockholder litigation or negotiation with the board. Although this appears to be supportive of the inside information argument, it is not unusual for a higher premium to be paid in a takeover where there is competition for control (Lowenstein, 1985; O'Sullivan and Wong, 2005).

More recent UK evidence relating to the second wave of buyouts in the 1990s/2000s finds that undervaluation contributes to shareholder gains and is a rationale for going private (Weir *et al.*, 2005b; Renneboog *et al.*, 2007). This evidence is only partly consistent with the early US evidence cited above; the undervaluation argument being more important in the UK, perhaps reflecting the significant numbers of PTPs completed where the founder had retained a significant equity stake.

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Longevity of the Performance Benefits of PE Buyouts

The PE firms have been criticized for their short-term interest in investee firms because they seek to make a return for the investors in their funds. The implication therefore is that the governance structure involving active monitoring by PE firms is short- to medium-term in nature because of their time horizon. Systematic studies consistently cast doubt on the view that PE buyouts are short-term investments; rather their longevity is heterogeneous (Kaplan, 1991; Wright *et al.*, 1993; 1994b; 1995; Strömberg, 2008). Most studies of accounting performance gain focus on a period of up to 3 years, with gains appearing to be less strong over 5 years (Phan and Hill, 1995). Evidence from exits also shows that PE-backed MBOs in the UK tend to IPO earlier than their non-PE-backed counterparts (Jelic *et al.*, 2005; Von Drathen and Faleiro, 2008).

A key problem with analyzing the consequences of PE firm exit and the termination of the LBO governance structure with active investors is that two competing arguments are observationally equivalent. First, if the theoretical prediction that the involvement of PE firms is integral to improving investee firm performance, the exit of PE firms, and the termination of the LBO governance structure will lead to a decline in firm performance. This will occur despite many firms retaining high leverage and a significant concentration of equity under management control after the buyout governance structure is terminated. This is because active monitoring by PE firms is a key ingredient in attenuating agency problems, which can re-emerge after PE firm exit.

Second, cost cutting in order to improve short-term performance will also mean that performance improvements are short-term in nature and are not sustained after exit if PE firms select the time of exit to optimize investee firm value. Evidence indicates that post-IPO performance of LBOs exceeds that of other IPOs, but this does not persist into the longer term (Holthausen and Larcker, 1996; Bruton *et al.*, 2002; Cao and Lerner, 2007).

Differences in Effects of PE Across Institutional Contexts

Most studies of the impact of PE buyouts have focused on Anglo-American markets. A number of multi-country studies are emerging but often do not distinguish between the importance of different markets (e.g., Gottschalg, 2007; Lerner *et al.*, 2008). Desbrières and Schatt (2002) do, however, suggest that the performance effects of buyouts may be different in the French market, especially for buyouts involving family firms.

The most notable evidence concerning the PE buyouts in different institutional contexts concerns the impact on industrial relations. Comparative research on buyouts in the UK and the Netherlands, the latter having a higher degree of employment protection, shows that the positive effects of buy-outs on employment practices are surprisingly greater in the less-regulated UK context than in the Netherlands (Bruining, Boselie, Wright and Bacon, 2005; Bacon *et al.*, 2008). A pan-European study of industrial relations (Bacon *et al.*, 2009) indicates that PE firms adapt their approaches to different social models and traditional national industrial relations differences persist.

PROSPECT: AREAS WHERE MORE RESEARCH IS NEEDED

The review in previous sections shows that there is a considerable body of evidence regarding PE. However, there remain a number of areas where greater understanding is needed to inform policy development and stakeholders of the unique impact and role of PE in the economy. We discuss areas where we need to know more about the themes addressed in the previous section in terms of: the likely future impact of PE buyouts on performance; the implications of active monitoring by PE firms for the nature of gains; the implications for different stakeholders, whether the performance benefits from PE buyouts persist; differences in the impact of PE buyouts in different institutional context; and the data challenges to enable the impact of PE to be assessed.

The Likely Future Impact of PE Buyouts on Performance

Comparison of Gains Between the First and Second Waves. There have now been two waves of buyout activity, creating scope for comparison between the two waves. It is too early to tell how well PE buyouts completed during the peak years of 2006 and 2007 have performed and the relative importance of efficiency versus growth strategies. Initial evidence concerning PTPs in the 1990s and 2000s is less convincing than that for the first wave in the 1980s. See Guo *et al.* (2007) and Weir *et al.* (2008b) for evidence concerning the latest wave and DeAngelo *et al.* (1984) and Kaplan (1989a) for evidence concerning the first wave. Further research is needed in this area.

Impact of Credit Crisis and Recession on PE Buyout Performance. The onset of adverse financial and economic conditions since mid-2007 raise especially important concerns for the future impact of PE buyouts.

Axelson, Jenkinson, Strömberg and Weisbach (2008) show convincingly that the share of debt in PE buyout financing structures is primarily related to debt availability conditions and contributes to increasing the premiums paid to acquire firms. The PE market reached its apogee in the middle of 2007 with the availability of debt from a variety of domestic and foreign sources at lower interest rates than in the first PE wave of the late 1980s (Figure 1). As the market neared its peak, the Financial Services Authority (2006) in the UK expressed concern that increased leverage would likely lead to higher failure rates. The 2008 global financial crisis has restricted the availability of debt resulting in the total value of deals falling substantially, a situation that is likely to continue for some time (CMBOR, 2008).

The average share of debt in the financing structure of UK buyouts was not markedly out of line with that seen in the earlier peak period (Figure 2). Kaplan and Stromberg (2009) consider that the financial structures of US deals completed in the second wave are on average less fragile than those

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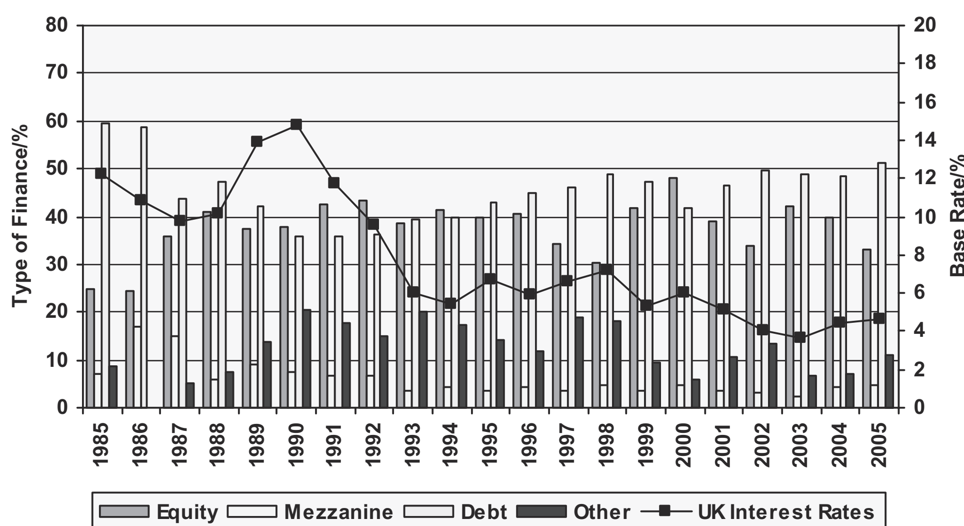
FIGURE 2
Average Buyout Structures and UK Interest Rates



Source: CMBOR/Barclays Private Equity.

completed in the first wave because of high coverage ratios, looser covenants, and lower leverage. They thus expect default levels to be lower than following the first wave.

Earlier research does indicate that higher leverage is associated with a greater likelihood of failure in buyouts (Wright *et al.*, 1996b). Furthermore, evidence from the recession of the early 1990s demonstrated a sharp increase in failures (Wright *et al.*, 2000b), particularly of MBIs, that had been acquired at high prices in the boom years of the 1980s. Notable examples in the UK included Magnet, Gateway, and Lowndes Queensway, three of the largest deals to have been completed at that time (Wright, Coyne and Lockley, 1994a).

Current indications are that failures of buyouts are rising (CMBOR, 2008) and a significant number of PE portfolio companies have debt that is trading at distress levels (Meerkott and Liechtenstein, 2008). The senior debt in the largest European PE deal, the KKR-backed Alliance Boots was reportedly trading at less than 60 per cent of par value and claims were made that it is impossible to attribute any real value to the equity (Arnold, 2009). Similarly, the holding company of the German broadcaster ProSiebenSat.1, bought for €8.50bn (£7.70bn) by KKR and Permira, had debt trading at 5 cents in the euro. A deepening recession is likely to see increased pressure on more distressed debt holders to sell at more discounted prices. Absent pressures to exit, however, the number of sellers may be reduced as long as firms are able to service their debt.

These conditions place major demands on the governance role of PE firms in securing the viability of their portfolio firms, which will have major implications for PE firms' fund performance and hence their ultimate survival.

On the other hand, previous recessions have been characterized by an increase in buyouts of distressed firms that have subsequently been restructured (Robbie, Wright and Ennew, 1993).[4] There may be opportunities for some PE firms to make acquisitions at attractive prices with a number of prominent players, such as Goldman Sachs, Blackstone, Carlyle, and Alchemy raising distressed debt funds to acquire debt cheaply and swap debt for equity.

Traditional debt conditions appear to be significantly more difficult than in the recession of the early 1990s when, although they were heavily involved in restructuring portfolio companies and many providers left the market, banks were not facing such severe capital constraints (Wright *et al.*, 2000b). Nevertheless, some notable deals involving distressed companies are already occurring, such as the EPIC PE-backed buyout of the tea and coffee retailer Whittard of Chelsea at the end of 2008 (Hall and Harrington, 2008). Whittard's principal owner was the Icelandic PE firm Baugur, which was adversely affected by the Icelandic banking crisis.

These conditions raise a number of issues where more evidence is needed. Further research is needed on whether PE-backed buyouts are more or less likely to fail than other comparable firms. Analysis is also needed of the extent to which more experienced PE firms are successfully able to restructure their portfolio firms. Problems may be greater in the largest, most heavily indebted buyouts, and examination of whether this is the case required. In the current debt constrained environment, may questions arise as to whether PE firms are able to raise sufficient funding both to restructure existing portfolio firms and to invest in new deals. Moreover, consideration needs to be given to the extent to which alternative PE providers that are not so reliant on debt, e.g., Sovereign Wealth Funds are emerging as a serious competitor to the PE model.

Influence of Active Monitoring in PE Buyouts on the Nature and Source of Gains

The Relative Importance of Different Governance Mechanisms. More systematic evidence remains to be generated on the extent to which gains in PE-backed buyouts result

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from efficiency and productivity gains, asset disposals, or from entrepreneurial growth. The relative influence of the different governance mechanisms involved in PE in generating these different changes and in different deal types needs to be examined. In particular, it is not clear which of the three main incentive and control devices (debt bonding, managerial equity ownership, and PE monitoring) is most important in determining efficiency and productivity change. For example, PE may be less effective without debt bonding and/or managerial equity ownership. More-detailed analysis of such issues would extend to examination of the role of PE syndicate members and potential conflicts/substitution effects between PE and debt providers in deals, particularly in distressed cases.

In the light of recent criticisms of the apparent negative effects of PE (in relation to employment, remuneration, R&D, and asset disposals), it needs to be appreciated how these governance mechanisms may differ between MBOs and MBIs.

The Process of PE Firms' Governance Role. There is limited direct evidence on the role of PE firms and boards relating to the first PE wave of the 1980s. More evidence about PE firms' roles is becoming available relating to the second wave after the late 1990s. Yet there remains limited analysis of the detailed composition and processes of PE investee boards, and that which is available is focused on a limited set of more mature PE firms. Further research is needed to analyze the process of PE firm involvement. Gaining access likely poses major challenges and by the nature of these activities, studies will need to adopt questionnaire and case study approaches.

Differences in the Governance Role of Types of PE Firm. Much research attention has focused on the role of independent PE firms that raise closed end funds. There is little research on the differing role and impact of the different types of PE firm outlined earlier. Examining these differences is especially important in different institutional contexts where the balance between independent PE, public sector PE firms, sovereign wealth funds, and captive PE firms that are part of banks and insurance corporations varies.

While the existing literature focuses on the governance relationship between investee firms and PE firms, a further governance relationship exists between the limited partners (LPs) that invest in PE (i.e., pension funds, etc.) and PE firms. LPs commit a certain amount of capital to a PE fund and the managers of the PE fund invest that money over a period agreed with the LP. At the time of committing capital to the fund, there is an agreement between the LP and the PE firm on when the capital will be returned to the LP. In the light of recent debate about whether PE funds outperform the stock market and the extent to which returns are generated from management fees or carried interest (i.e., share of the capital gain), further work is needed on the governance relationship between LPs and PE firms and how this feeds through into the involvement of PE firms in their investees to create value.

Implications of PE Buyouts for Different Stakeholders

Much of the current policy and practitioner debate has questioned the focus on the distribution of returns to shareholders in PE-backed buyouts (e.g., the PSE Group in the European Parliament, 2007). These concerns have led to suggestions that governance structures need to be put in place that allows for wider ownership and involvement by the wider body of employees that are not part of the senior executives in the buyout company or the PE firm.

The importance of PE-backed buyouts involving family firms suggests a need for further theoretical development that considers the role of stewardship factors in governance. This could include consideration associated with PE-backed buyouts of family firms representing the crossing of a threshold in the life cycle of these firms that involves a shift from a family firm governance structure that might pursue family objectives that are non-profit-maximizing to a more professionalized governance structure with a profit-maximizing objective. Alternatively, the shift to a new, concentrated group of managerial owners with PE may provide scope for a conceptual extension of the notion of family firm governance as it is metamorphosed into a more professionalized structure. These developments may also involve the possibility to extend the agency perspective through integration with a stewardship perspective.

Persistence of the Benefits of PE Buyouts

There is some evidence that recent PE-backed deals are taking longer to exit than earlier ones (Wright *et al.*, 2007a). Longevity may further increase because of recession for the more successful transactions, while less successful deals may fail more quickly. This likely has associated implications for the nature of value creation that needs to be examined.

The growing number of secondary buyouts means a prolongation of the PE structure, but with a changed PE composition between the first and second deal. These transactions raise important unresolved issues relating to the differences in performance between first and second buyout and what governance mechanisms drive this difference.

Differences in the Effects of PE Firms Across Institutional Contexts

Although our review shows there is some international evidence, this is somewhat patchy. While the impact of PE depends on the variety of capitalism in a particular country (Hall and Soskice, 2001), there may be room for experimentation and adjustment within institutional contexts (Hall and Thelen, 2008). Thus, PE firms may adapt their approaches according to whether they invest in countries with social models that involve stronger co-determination legislation or in countries with more liberal market legislation. The link between institutional context and the nature of PE governance needs to be examined further.

Further analysis might usefully consider whether there is evidence of market segmentation. For example, there may be cross-institutional context similarities in the nature of governance among the largest PE buyouts that attract interna-

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tional investors, while there may be significant differences at the smaller deal segment of the market.

International or cross-border investment by PE firms is long established, but recent developments in PE and buyouts have been marked by an increase in this kind of activity. For example, over the past two decades, the number of UK buyout deals backed by non-UK PE firms has risen almost threefold, while their deal value has risen 10-fold (CMBOR, 2008).

Buyouts backed by domestic PE firms were initially seen as playing a role in indigenizing foreign-owned subsidiaries and/or divisions (Wright *et al.*, 1994a). However, buyouts backed by foreign PE firms have attracted policy interest, especially in continental Europe, as they may reduce indigenous ownership and be associated with Anglo-American forms of corporate governance that may exacerbate the often-claimed short-term investment horizons of PE firms. In contrast, foreign PE investors may bring greater expertise to reinvigorate underperforming firms and may provide access to foreign markets both for domestic PE firms, through syndication, and for investees (Mäkelä and Maula, 2006).

Foreign PE firms entering overseas markets may face higher transactions costs in both identifying and monitoring investees. By virtue of their foreignness, they also likely experience greater information asymmetries and lower social capital. These characteristics raise important issues regarding the governance approaches of foreign PE firms compared with their domestic counterparts that as yet are not well understood. Future research could usefully examine these governance issues. For example, to what extent do foreign PE firms attempt to address asymmetry of information issues by taking greater control in their investee companies through taking higher equity stakes in investee firms than domestic firms? To what extent are foreign PE firms more likely to invest in buyouts of publicly listed corporations and overseas divisions of corporations in their home markets where the information asymmetries they face may be lower? To what extent are foreign PE firms more likely to invest in larger deals in order to reduce transaction costs and outsider-led deals accessed through auctions as they do not possess the social capital to access proprietary insider-led deals? To what extent are foreign PE firms more likely to adopt governance mechanisms involving less intensive monitoring in order to reduce higher transaction costs? To what extent do foreign PE firms adapt their approaches as they enter different institutional contexts.

Data Challenges in Enabling the Effects of PE Governance to be Assessed

Critiques of PE have major implications for the kind of information needed to assess the effects of PE governance in a comprehensive and objective manner. As with the Cadbury Report on corporate governance in 1992, the UK has become the first country to implement disclosure guidelines as a result of the recommendations of the Walker Report (2007), with other countries, such as Denmark, also preparing such moves, and the European Parliament as well.

A first challenge is the need to provide data on the full size, vendor, and industry source range as failure to do so may lead to partial understanding of the phenomenon of PE-backed buyouts at best. This has important policy implications, e.g., in respect of the Walker Guidelines (Walker, 2007) in the UK that propose that only deals with an enterprise value above £500 m are covered by reporting requirements. Such a focus does not enable comprehensive, industry-wide monitoring. Although extending coverage to a broader segment of the market raises potential issues about the burden of reporting, it would make for more reliable, meaningful, and balanced monitoring of the PE industry as a whole, including understanding of the role of different types of PE firm in different types of deals and contexts, which may be in the longer-term interests of both the industry and the economy in general.

The availability of larger online databases has helped facilitate the development as well as the construction and analysis of large panel datasets that help overcome problems associated with the analysis of a small number of larger transactions that may not be representative of the PE market as a whole. Nevertheless, many of these datasets are not comprehensive as they are compiled from publicly declared transactions and often exclude smaller deals. An exception is the Center for Management Buyout Research database which includes all deals, irrespective of size, whether publicly declared or not, and whether PE-backed or not. A recent important indicator of an industry-based initiative to address this issue is the establishment by the European Venture Capital Association of PEREP Analytic with a mandate to provide neutral, bias-free data, and research across Europe, with data provided by member firms and with a governing board composed of academics who will provide supervision and audit of all research processes.

However, such databases are only a first step in the process of providing objective, comprehensive data on PE. In order to meet the important critique that studies conducted by the PE industry in particular have typically not controlled adequately for general environmental changes, in the new high profile context and scrutiny of PE, a second challenge is to construct appropriate control samples. If PE firms select buyouts randomly from the population of firms, a randomly constructed control sample will suffice for unbiased inference to be made. If, as seems likely, buyouts are not selected randomly from the population of firms, results using a randomly constructed control sample will suffer from selection bias. For example, a firm may be a buyout target because it overemploys and/or makes extra-marginal wage payments from which cost savings can be made in the post-buyout firm. This is a non-trivial issue with major policy implications if not addressed adequately, as biased conclusions about the consequences of LBOs may be the result.

CONCLUSIONS

In this paper we have reviewed the evidence relating to what we know about PE buyouts under several themes that we summarize in Table 3. There is clear evidence from our review of improvements in accounting profits and efficiency going back over two decades. Gains are not limited to cost cutting but also include benefits from entrepreneurial

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TABLE 3
Summary of Review Regarding Private Equity (PE) Buyouts

THEMES	RETROSPECT	PROSPECT
What are the short- and medium-term performance gains from PE buyouts?	Short- to medium-term gains in accounting performance, efficiency (productivity and cost reductions), and entrepreneurial actions (e.g., new product and market development; patent citations and better use of R&D)	Will gains from second wave of buyouts be below those for first wave? What will be the impact of recessionary conditions on the performance of PE firms and their investee companies?
What is the role of active investors and other governance mechanisms?	Active, experienced, and specialized PE investors and management equity ownership especially important in generating performance gains.	How do active investors affect corporate governance? How does governance differ between different PE firms?
Are there transfers of wealth to/from employees after PE buyout?	Initial reduction in employment followed by subsequent increases in employment, especially in Management Buyouts (MBOs); wage effects less positive especially for Management Buy-ins (MBIs)	What is the appropriate role and scope for wider employee ownership in PE buyouts? Do certain employee groups benefit while other employee groups suffer from PE buyouts?
Are there transfers of wealth? to/from shareholders after PE buyout?	Debate about role of insider information, but managers' *perceived* undervaluation important in recent PTP buyouts.	How does PE affect different kinds of shareholders (e.g., family, institutional, banks, government)?
Do gains persist from PE buyouts over time?	Accounting and market performance gains most notable over 3–5 years for most firms. IPOs are a special exit case, but performance differences with non-PE firms persist although at a declining rate. In the short term, the benefits appear clear to outgoing owners and to the new owners and management while in the longer term the benefits are less clear. While non-financial stakeholders argue that other stakeholders suffer in the short and long term, the evidence to support this view is at best mixed.	To what extent are there differences in the persistence of gains in initial deals and secondary buyouts
Does the national institutional context influence PE buyouts?	Most previous research conducted in the US and UK. Compared with these two governance environments elsewhere there are concerns over the sources of deals, less positive entrepreneurial attitudes to doing PE buyouts, less favorability of infrastructure to do deals, and availability of exit markets. More positive attitudes are emerging elsewhere, but at a variable rate	What are the links between national institutional context (varieties of capitalism) and the nature of PE governance? How do foreign PE firms adapt their governance approach when they enter overseas markets? How do PE buyouts complement or conflict with other governance mechanisms?

growth strategies. Claims of negative effects on employment are questionable, especially after an initial shakeout. Positive employment effects are especially notable for insider-driven MBOs, but not outsider-driven, MBIs, which likely involve more turnaround candidates. The active monitoring role of PE firms is an important contributory factor to the gains identified, with more experienced PE firms more likely to be more successful in generating performance improvements. The gains from PE-backed buyouts also appear to be sustained at least into the medium term. While PE-backed buyouts have diffused beyond Anglo-Saxon countries, their relative importance has generally been lower as a result of a variety of institutional constraints relating to attitudes to entrepreneurship, willingness of owners to sell to PE firms, the infrastructure to complete deals, and the availability of exit markets.

Despite this evidence of widespread beneficial effects, we have also identified that future studies are needed, and these

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are summarized in Table 3. A major question concerns whether gains from the second wave of PE buyouts will be in line with or below those for the first wave; initial indications suggest that gains from PTPs may well be lower. There is emerging evidence of heterogeneity among PE firms and further evidence is needed on the detailed processes engaged in by PE firms and how these differ between PE firms. Further research is also needed to consider the effects of PE on stakeholders. Specifically, in the light of policy debate concerning the distribution of gains to PE, the role and scope for wider employee ownership in PE buyouts needs to be examined. Further analysis is needed of how PE affects different kinds of shareholders and stakeholders, including family shareholders. As secondary buyouts become one of the most important exit routes, we need to know more about the persistence or otherwise of gains in these kinds of deals that prolong the PE governance structure. Previous PE research has had a US/UK bias, but with the international growth of PE markets, there is an increasing need to examine the links between institutional context, the nature of PE governance, and the impact on performance. Specifically, there is a need to consider whether PE firms can transfer their business model directly to non-Anglo-Saxon environments or whether and how they need to adapt it to local circumstances.

Our review identifies important implications for theory. The dominant agency theory perspective has provided major insights into the PE phenomenon. Its emphasis on resolving control and incentive problems in large diversified firms has tended to focus on downside protection for owners (Wright *et al.*, 2000a). Yet, the heterogeneity of buyout sources and methods of value creation we have identified highlights that there may be opportunities for upside value creation that are not simply due to better control and incentives, but which may require different cognitive skills (Wright *et al.*, 2000a) and that there may be opportunities for buyouts where pre-ownership change agency problems are not significant (Wright *et al.*, 2001). There is therefore a need to develop further the complementarity between agency and other theoretical explanations of PE-backed buyouts. First, entrepreneurial perspectives, such as cognitive and strategic entrepreneurship approaches, are being developed to help explain value creation through the exploitation of entrepreneurial opportunities (Wright *et al.*, 2000a; Meuleman *et al.*, 2009), but further work is needed to delineate the complementarity of agency and entrepreneurship theories in different contexts. Second, the agency perspective has been applied to the family firm context in general (Schulze *et al.*, 2001) and the importance of PE-backed buyouts involving family firms suggests a need for further theoretical development that synthesizes agency and stewardship perspectives. Third, the current debate regarding the distribution of returns to PE suggests a need to give further consideration to aspects of stakeholder governance. For example, there is an extensive theoretical and empirical literature relating to employee participation and further research might usefully build on some preliminary work in this area (e.g., Pendleton, Wilson and Wright, 1998) in the context of PE-backed buyouts. Fourth, given the diffusion of PE beyond traditional Anglo-Saxon contexts, there is a need to theorize the role of PE in different institutional environments. In a more general governance context, prior studies that combine agency and institutional theory perspectives have shown that differences in national institutions impact on the effectiveness of corporate governance at the firm level (Aguilera and Jackson, 2003; Aguilera, Filatotchev, Gospel and Jackson, 2008). Future studies should build on this work specifically in relation to PE.

Our review of the literature raises a number of implications for practice and policy. With respect to practice, there is a need for managers and their advisors to be aware of the heterogeneity both of opportunities to create value in PE-backed buyouts and of the different expertise of PE firms in helping realize that value. Some PE firms may be better skilled at providing expertise to help grow their investee firms while others may have greater skills in financial monitoring. Evidence that higher leverage in PE-backed buyouts is associated with a greater likelihood of failure has particular resonance in the current credit crisis and recession. PE firms and managers need to pay particular attention to understanding the ability of portfolio companies to service debt burdens under assumptions about future market developments that allow for significant fluctuations in cash flows.

Our review has highlighted the importance of systematic evidence to inform the recent extensive policy debate about PE. Proponents argue that PE presents a superior form of corporate governance to that found in listed corporations and that it produces superior performance in firms subject to PE governance. Critics argue that PE wealth gains arise because of wealth transfers from other stakeholders. While the critics of PE have garnered considerable media and policy attention, their claims are generally at variance with the main body of evidence. Policymakers designing mechanisms to regulate PE need to be aware of the systematic evidence that shows a more positive impact of PE than some have claimed. But they also need to be cognizant of the evidence that there are heterogeneous effects relating to different types of buyout and PE firm that need to be taken into account. The evidence also indicates that critiques of PE based on the initial effects of buyouts are short-termist and risk foregoing longer-term benefits to be had from restructuring underperforming businesses.

Similar criticisms were also raised during the first wave of PE buyouts in the 1980s, especially in the US (e.g., Jones and Hunt, 1991). That the claims appear to have been more vehement and sustained during the second wave seems to be partly due, in Europe at least, to the emergence of PE buyouts of larger corporations than hitherto. But it is doubtful that this provides a full explanation. The evidence from the second wave of PE buyouts is broadly consistent with that from the first wave in terms of effects on employment, longevity, and leverage. In continental Europe, traditional European Social Models, which place greater emphasis on stakeholders than shareholders, have come under considerable pressure to adapt to global competition, but not without resistance. Together with a resurgent trade union movement, this has contributed to forceful critiques of the liberal economies model that have found support in the media and in some political quarters, as we noted at the outset. In these circumstances, PE is an easily identifiable target. Yet, there is a danger that such politically driven attacks risk driving out the

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undoubted benefits of PE. In the current radically changed economic landscape, there seems more than ever to be a need for careful systematic assessments of the contribution of PE.

NOTES

1. Detailed description of the PE investment process is beyond the scope of this article. Full details are contained in Gilligan and Wright (2008).
2. Opler and Titman (1993) consider financial distress cost as a factor deterring a PTP buyouts in the US. In contrast, Sudarsanam, Wright and Huang (2007), employing a direct measure of bankruptcy risk, find that PTPs have significantly higher default probability. They report that returns are higher for target firms faced with higher bankruptcy risk suggesting a strong turnaround motivation for the PTP deal.
3. Asset disposals following PE deals are sometimes pejoratively seen as asset stripping, in the sense that they imply that an investor does not have a long-term commitment to a firm but seeks to make a short-term profit from the sale of its assets. Although this can occur, it must be distinguished from the sale of underperforming assets in conglomerate firms.
4. The process of buyouts of distressed firms has been facilitated by the introduction of "pre-packs" where a deal is agreed prior to entering administration to sell the business as soon as it enters the insolvency proceeding. This process can clear some of the debts for the new owner, but raises questions as to whether creditors are being disadvantaged.

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