WHAT DRIVES THE CAPITAL STRUCTURE OF EUROPEAN LBOs? (SUMMARY)

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SUMMARY

WHAT DRIVES THE CAPITAL STRUCTURE OF EUROPEAN LBOs?

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Principal Topic

Financing has been compared to the “fuel” that propels entrepreneurial activity and drives economic growth. Appropriate capital structure may facilitate financing for projects that would otherwise be forgone. Capital structure decisions have been shown to matter for failure, firm performance, and business expansion. We examine the capital structure decisions in LBOs, which hitherto received little systematic attention. There is a growing recognition that buy-outs involve major entrepreneurial activity. They provide incentives, financial resources and professional management that enable bought-out firms to pursue additional profitable opportunities.

In explaining observed financing choices we test relationships between the characteristics of buyout investors and their target firms on one hand, and the choice of capital structure used in the acquisition of these targets on the other. Extant literature uses three theories to explain capital structure choices – trade-off theory (a trade-off between the debt’s tax advantage and financial distress costs); market timing model (the relative costs of equity and debt) and pecking order theory (preference to issue the safest debt first). Given the peculiarities of the LBO setting, pecking order theory offers particularly good explanation of the proportion and types of debt.

Method

We draw on a sample of European LBO transactions obtained from Dealogic and Capital IQ databases. In our analysis, we test the impact of (i) target firm characteristics (industry, operating profit, sales, assets, enterprise value multiple); (ii) investors’ characteristics (domicile, size) and (iii) the LBO deal parameters (debt structure, transaction type, averaged seniority, average maturity).

Results and Implications

Our preliminary results offer strong support for pecking order theory. Nonetheless, the other theories are also instrumental in explaining the capital structure of LBOs. Potential investors and managers aim to maximize their returns through greater reliance on debt by utilizing a range of debt types that differ in the priority of residual claims. The availability of these different types of debt facilitates higher tax shields without proportionally increasing bankruptcy costs. This may explain why leverage levels in LBOs are much higher than those observed in corporate settings. The implication of our findings is that the existence of debt types with different levels of priority of claims may contribute to financing of projects that would otherwise be forgone.

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