EFFORT OF PRIVATE EQUITY IN BUYOUTS REVISITED (INTERACTIVE PAPER)

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Principal Topic

How does adding effort create value in later-stage buyouts? In all lifecycle stages of a portfolio company (from startups to firms in decline), private equity financiers (PEFs) may facilitate buyouts. In order to let PEFs maximize the value of their investments, they need to carefully consider how much effort should be invested in portfolio companies (PFCs) in addition to the capital investment. The early stage finance literature describes well how PE may add value at all (Meier, 2006; Busenitz et al. 2004; Baum & Silverman 2004; Kaplan & Strömberg 2004; Barney et al. 1996; Sapienza et al. 1996; Gorman and Sahlman 1989).

Buyouts typically occur in a later stage of a company’s lifecycle. Contrasting with the early-stage venture capital literature little is known about any potential boundaries to adding PE effort in later stage buyouts. Therefore our paper examines the optimal provision of effort by the PE, and the way effort should be addressed in order to increase the value of the PFC.

Method

We propose a simple value maximization model and analyze the first order conditions under which there exists an optimal effort level and specify the limits to the private equity involvement. Our model relates the value of the extra involvement in a buy-out to (a) the potential for scale economies, (b) the price elasticity of demand for the firm’s output, and (c) the realized markup on the sales. The model allows us to identify five cases in which effort is expected to either have an unlimited value-creating potential, to have some optimal level, or to be value-destroying. In each novel case study firm we have interviewed the general director and/or the chief financial officer involved in the buy-out and still employed in the firm post-buy-out, and the PE investor.

Results and implications

In all case studies, the PEFs cut costs. The more we move from the growth towards the decline phase, the more the PEF is involved strategic business decisions. Though all PEFs aim at realizing growth spurts, the role of the PEF is restricted to controlling costs, and advising and enhancing the entrepreneur to optimize the business decisions. The PEF never take upon the role of the entrepreneur. PEF monitoring frequency increases when the business moves towards a critical or distress situation, and decreases when the business is stable.

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