6-6-2009

EFFORT OF PRIVATE EQUITY IN BUYOUTS (SUMMARY)

Arjen Mulder
Rotterdam School of Management, Erasmus University, The Netherlands, amulder@rsm.nl

Hans Bruining
Rotterdam School of Management, Erasmus University, The Netherlands

Recommended Citation
Available at: http://digitalknowledge.babson.edu/fer/vol29/iss17/4

This Summary is brought to you for free and open access by the Entrepreneurship at Babson at Digital Knowledge at Babson. It has been accepted for inclusion in Frontiers of Entrepreneurship Research by an authorized administrator of Digital Knowledge at Babson. For more information, please contact digitalknowledge@babson.edu.
SUMMARY

EFFORT OF PRIVATE EQUITY IN BUYOUTS

Arjen Mulder, Rotterdam School of Management, Erasmus University, The Netherlands
Hans Bruining, Rotterdam School of Management, Erasmus University, The Netherlands

Principal topic

The PEF has no unlimited resources for dedicating infinite amounts of effort to each individual company in her portfolio, and she faces the standard opportunity costs of effort (cf. Shepherd et al. 2005). We assert PEF’s are undiversified investors who have a strong incentive to maximize the value of each individual investment (cf. Sorensen and Stuart, 2008). Even though prior research shows whether and how PEF effort creates value in the investee firm, it remains unknown how much effort the PEF should add in the case of buyouts. We aim to fill the gap by proposing an integrated theory that addresses whether value is created by defining the components of value (creation), how value is created by describing the action-outcome relationship, and how much effort is dedicated by analyzing the distinct roles of the PEF and the entrepreneur of the investee firm. Our theory seeks optimal PEF effort levels for value creation in private equity-backed buyouts.

Method

We combine a rational financial-economic value maximization model (cf. Casamatta, 2003) with Vroom’s (1964) expectancy theory. The rational model provides us with the necessary conditions for value creation in different stages of the investee firm’s lifecycle. In terms of Vroom, the model delivers the rational PEF action-outcome association (expectancy). As value of PEF effort can also be non-financial, we enrich our model with prior research to define the potential for value creation per lifecycle stage (valence). Together, we develop propositions regarding the nature and level of PEF effort that creates positive value which is Vroom’s outcome-outcome association (instrumentality). We analyze the valence, expectancy, and instrumentality of PEF effort in four case studies. We have interviewed both the PEF and the CEO or CFO of the investee firm, and have analyzed secondary data (company reports, press articles, etc.).

Results and implications

Although our value maximization model predicts limited value creation or even value destruction in the later lifecycle stages, we observe PEFs try to escape from these negative outcomes by formulating action-outcome relationships that push the firm back into profitable stages of the lifecycle. Valence is updated through monitoring, soundboarding, and if necessary through active PEF participation in the investee firm’s board. Updated expectations make PEFs allow for adjustments in the level and nature of effort, for additional investments by the investee firm, or for changing the scheduled moment of the exit. Our findings feed new propositions about the nature and level of effort in buyouts.

CONTACT: Arjen Mulder; amulder@rsm.nl; (T): +31.10.4081929; (F) +31.10.4089017; Rotterdam School of Management, Erasmus University, P.O. Box 1738, 3000DR Rotterdam, The Netherlands.