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**SHORT-TERMISM IN CURRENT FINANCIAL CAPITALISM. AN
EXTENSION TO THE PRIVATE EQUITY INDUSTRY**

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ABSTRACT

In a context of an increasingly focus of market participants on short-term results rather than on innovation or sustainability of the firm, we question its extension to a special case of the private context: the private equity industry. Opposite to other researchers that use expropriation and short-termism as equals, we dig into the narrow line that separates both terms. We theorize about the concept of short-termism, offering an alternative vision. In the second part of this project we use the financial statements of a sample of private equity buyouts in Spain from 2001 to 2011 to test five different scenarios (two of them corresponding to short-termism) and thus shed light into the impact of LBOs on the acquired firms' performance. Results provide support on the presence of expropriation, in contrast with the arguments claimed by the private equity official narrative.

KEYWORDS: Short-termism, Expropriation, Leveraged Buyouts, Private Equity.

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1. INTRODUCTION

A period of financial firms seeking short-term profit careless of the long-term consequences preceded the financial crisis of 2007-2009. The presence of short-termism is a current topic that the global economy and the Spanish one in particular might be suffering; it can desolate firms and the economy in general (Dallas, 2012).

My interest in accounting and finance has allowed me to consider not only the benefits that these disciplines provide, but also their drawbacks, and undoubtedly, short-termism is one of them. It leads to insufficient investment in improving the long-term performance of the company because practices with the aim of boosting companies' share price, revenues and profits are preferred to those concerned on quality, innovation and sustainability of the firm. Bearing in mind, however, that short-termism has been always considered a "market" issue and that in Spain there are not many publicly-held firms, we have focused our study on the private context. This allows us to better appreciate the extent to which short-termism might be affecting our country.

The purpose of this project is to deep in the concept of short-termism not only in the public market but also in the private context, especially emphasizing the analysis in the private equity industry. Short-termism has been always attached to the market given the pressure that managers face from activist investors and analysts that make most of their decisions based on short-term indicators. Considering both that private firms do not suffer this pressure and that the statistics show that they invest much more than public firms in long-term investments (Asker, Farre-Mensa & Ljungqvist, 2011), we should expect that managers in private companies offered a more long-term oriented view. Nonetheless, there might be reasons why short-termism affects the private context too.

The private equity industry, in particular, has been the subject of intense criticism for similar reasons, namely, for *expropriation* and *short-termism*. In leveraged buyouts (LBOs from now on), which nowadays represent the largest share of private equity investments in the European Union (Ughetto, 2012), companies are acquired by specialized investment firms using a relatively small portion of equity and a relatively large portion of outside debt financing (Kaplan & Strömberg, 2008). Even though the arguments of the industry's official narrative highlight the advantages of both concentrated ownership and high debt to create value for the company, there is also great concern on the potentially negative effects of these transactions.

Major cutbacks in investment and employment documented in LBOs are alleged to compromise the long-run competitive position of a firm in order to increase short-run cash flows (Ayash, 2018). Research has so far been done to provide evidence on the adverse effects that LBOs imply to acquired companies but often, expropriation and short-termism terminology are interchangeably used.

We further study the limits between expropriation and short-termism in private equity as we present a comparison between both strategies. *Short-termism* is concerned on signaling operating indicators until exit so as to benefit from a higher exit price whereas *expropriation* is more related to cash generation with a lower aim in signaling because less concerns on the exit price exist. Cash funneling during the holding period would be enough for the private equity fund to benefit from the LBO.

Namely, we deep into the Spanish private equity industry and we theorize on different scenarios that might arise. Consistent with our own vision, we describe two different scenarios for short-termism and one for wealth expropriation. We also include two favorable scenarios that sum up the five hypotheses tested. We use a sample of 358 Spanish firms that have been acquired by private equity funds in leveraged buyouts transactions between 2000 and 2011.

By applying the value generation framework of Berg & Gottschalg (2005) and with the intention of providing evidence regarding which of the five scenarios defined takes place, we track operational measures from two years pre-acquisition to at most five years postacquisition. We use 7 outcome variables to examine LBOs that include primarily operating performance and profitability measures, investment and working capital management measures. These estimates show that the expropriation hypothesis is not rejected so we can conclude that no operational improvement is achieved in these companies. Results provide evidence on the limits that the actions behind expropriation present too. The official narrative of the private equity industry Jensen (1986) is therefore contradicted.

The remainder of the project proceeds as follows. Section 2 provides the theoretical background of the origins of short-termism in the market, Section 3 questions its limitation to just publicly-held companies and Section 4 focus the presence of short-termism in a special case of the private scene: the private equity industry. In Section 5 we define the five potential scenarios and describe the framework under which those scenarios are going to be studied. Sections 6 and 7 include the data and methodology used and the empirical results are displayed in section 8. A final discussion is presented in section 9.

2. SHORT-TERMISM. ITS ORIGINS IN THE MARKET.

The focus of companies in the short-term rather than in longer and more sustainable profitable investments is a constant in public stock markets. Given that public companies are the most important ownership model in economies such as these of the USA, northern Europe or Japan (Johnson, Whittington & Scholes, 2011), it is more common to find shorttermist behavior in those geographic areas.

According to a survey by Graham, Harvey, and Rajpogal (2005) that involved 400 U.S executives, management teams center their attention on short-term earnings and feel pressed to meet earnings benchmarks with the purpose of building credibility and external reputation, increasing or at least maintaining stock price. Managers admit that they would be willing to delay advertising expenditure or profitable long-term projects in order to meet investors' expectations. These expectations are made with increasingly shorter views.

Activist investors or *shareholder activists* as they usually called themselves, are those that often penalize firms when they go for profitable but long-term oriented investments (Bøhren, Priestley & Ødegaard, 2005). They mostly search for short-term profits. Carl Icahn, one of Wall Street's most successful investors (Forbes, 2019), is a good example of this group. Since the moment Apple announced it would pay off investors with \$17 billion, this man promptly began to buy Apple stock (Foroohar, 2016) notwithstanding that the company's R&D investment was falling. Activist investors seek high-profile firms with abilities to boost share prices and have less interests in long-term related indicators.

Warren Buffet, who is considered one of the most valuable investors of all times, is nonetheless a representation of a different type of investors. He has several times stated that he looks for businesses that will continue to have a competitive advantage in the long-term (CNBC, 2018). He even suggested the avoidance of quarterly reporting to prevent managers from focusing so heavily in the short-term. Overall, investors of this sort appreciate firm's decisions beyond those that just focus on more immediate results.

But what exactly is short-termism, and which consequences do short-termist strategies imply?

Short-termism consists of an exaggerate focus of corporate managers, investors and analysts on the short-term results without being concerned on long-term value creation (Dallas, 2012). The first and most obvious implication of short-termism is the insufficient investment in projects that can lead to better long-term performance of the company. In other words, practices with the purpose of increasing companies' share price, revenues, gross and

operating profits, productivity and return on capital are preferred to those that are concerned about quality, innovation, employee's skills and training, brand reputation or social responsibility. In short, sustainability of the firm.

Financialization has become today's face of capitalism through changes in various parts of the economy. At the company level, it is linked to the *shareholder model* approach to corporate governance, the model that gained momentum in the US and the UK from the 1980s on. It encourages financialization of the company by maintaining that the purpose of its existence is to maximize the value of its shares rather than its long-term profits (ITUC, 2017). Other strategies also common in this corporate model are active use of debt, organizational restructuring and share buy-backs. Clearly influenced by this model, the primary duty of management is to maximize shareholder returns (Smith, 2003).

Companies, however, are much more than just shareholders and that is the main reason why an alternative model of governance was founded: the *stakeholder model*. Stakeholders can be defined as a group or individual who can affect or is affected by the achievement of organizational objectives (Freeman, 1984). Therefore, all stakeholders are essential for the performance of the firm, not only shareholders. Some of the common practices that are positively regarded by shareholders and thereby the ones usually chosen by management, do not consider stakeholders' interests though. This is critical since short-term oriented actions, usually taken to please shareholders, penalize the rest of the stakeholders and with them, the long-term sustainability of the firm. Some of these operations include "skimping on investment, exorbitant pay, high leverage, silly takeovers, accounting shenanigans and a craze for share buy-backs" as a result of shareholder value thinking (Forbes, 2017).

A good illustration of the pressure managers receive from activist investors is what happens to big companies like Microsoft, Pfizer or IBM when they announce new investments (e.g. the expansion to PC business that IBM carried out in 2004). The market reaction to these long-term oriented decisions is, in general, an immediate decrease in the share price. On the contrary, when embarking on short-term oriented practices (e.g. Microsoft embarked on a buyback process that same year) the response of investors is notable different. These are examples of how the market penalizes companies that focus their decision making in longrun projects disregarding the fact that the nature of their activities makes them indispensable to engage in such investments.

Capital markets are not currently the important source of inspiration for innovation that they are supposed to be. A "financialization" mindset, characterized by being a short-term view,

both prevents the economic growth and ensures just that rich people get richer. That is bad not only for those at the bottom, but for all of us. Research proves that more inequality leads to poorer health outcomes, lower level of trust, more violent crime, and less social mobility (Foroohar, 2016).

Apart from the activist investors, managers feel also pressure from market intermediaries such as analysts. Directors wish to please them because their recommendations can be very influential with investors' decisions. Research has found that firms engage in earnings management to achieve analysts' targets (Richardson, Teoh & Wysocki, 2004). On account of this, executives will adapt their decisions to achieve good analysts' reviews. Yet, this is not the sole issue regarding analysts; these might also be induced to issue their reports with a short-term oriented view. As shown in the dot-com crash of the early 2000s, in which many participants were to blame, financial analysts were recommending buying shares although they were well aware that those companies were overvalued (Palepu, 2017). Why did they then give such purchase recommendations? There is no doubt that they were blinded by the short-term.

In parallel and with the purpose of aligning management incentives with these activist investors and analysts' desires, *new forms of compensation* have emerged in the last decades such as payments based on stock options programs or on accounting-based performance measures, creating a model that links incentive compensation with performance (Jensen and Murphy, 1990).

Proponents of stock options claim that this form of compensation generates incentives for managers to artificially and temporarily maximize shareholder value. They provide managers with stimulus to understate or inflate earnings depending on the timing of the execution of the option (Palepu, 2017). These new forms of compensation create additional motivations for managers to work against long-term decision as it is simple to modify their decisions regarding the attractiveness that focusing on the stock option window presents for them. Oversized incomes have incentivized young people to work on Wall Street rather than in more socially productive venues; the prevalent forms of remuneration and tax incentives have led to excessive focus on short-term profits (Epstein & Montecino, 2016).

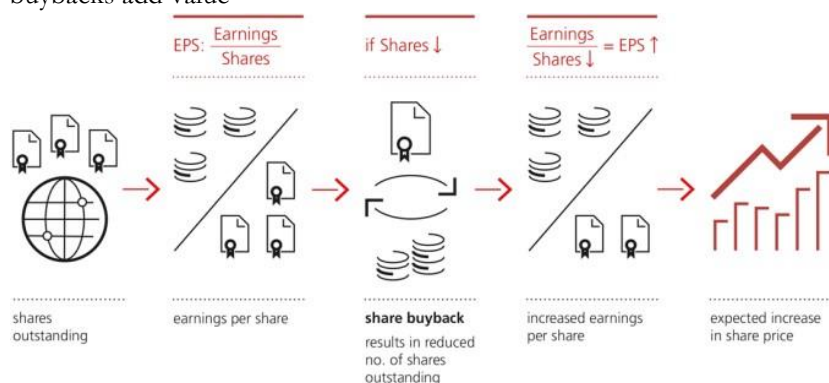
In part related with stock options, *buybacks* are a mechanism increasingly used by firms that might also induce to short-termism. Goldman Sachs estimated that in 2018 corporate stock buybacks would hit a record of one trillion dollars that year, jumping 51% from last year's mark (NBR, 2018). In those shares repurchase processes, the company pays cash to buy its

own shares in the stock market and therewith the number of shares outstanding is reduced (Bodie, Merton & Cleeton, 2012). Jeff Cox (2019) claims that if current conditions persist, corporations are likely this year to inject more than \$2.5 trillion into what UBS strategists term "flow" - the combination of share buybacks, dividends, and mergers and acquisitions activity.

Buybacks are practices where excess cash of the company is used in strategies with no direct longer-term focus. This cash could have been used to pay higher wages or to invest in research, infrastructures, workers' skills or product development. Still, what are the actual reasons behind these practices?

Foroohar (2016) considers buybacks as the last choice of a company when it knows that there is nothing else to do to keep high prices when prosperous times are about to end. A proof of this is that historically, when buybacks peak, they are followed by slower growth. The immediate consequence of a buyback is the increase in the earnings per share because of the decrease in the number of outstanding shares (see Figure 1). In periods of slow growth, it seems to be a good option so as to feign better results and satisfy investors. However, although there is an increase in earnings per share, there does not have to be movement in profits at all and that is what most of the time actually happens. The rise in corporate stock buybacks that have taken place concurrently over last decades clearly reflects a short-termist behavior of companies trading publicly.

Figure 1: How buybacks add value



Source: Taken from UBS

Another way a corporation can distribute cash to its shareholders is by paying a *cash dividend* (Bodie, Merton & Cleeton, 2012). Dividends can also represent a short-termist strategy depending on the circumstances in which they are declared. It is obvious that shareholders are risking some of their money when they invest in a company and, as a result, they should

expect to receive something in exchange. Yet, when companies invest all their excess cash in rewarding those investors instead of, at least, using part of it in more long-term oriented investments, we consider that there is a clear sign of short-termism. Even more serious are cases like Apple, one of the world's most valuable corporation, that in 2013 borrowed \$17 billion in order to pay dividends (Foroohar, 2016). It is surprising that a firm selling thousands or even millions of devices and with enough cash sitting in the bank, asks for debt with absolutely financial rather than operational objectives. There is no doubt that Apple did not need that money to develop a new product or to build new plants, it needed it to persuade investors by repurchasing stock or by paying higher dividends and thereby the company's strategy is tremendously short-term oriented.

Mergers and acquisitions (M&A) also represent a practice subject to short-termism that is achieving record levels. M&As frequently grab the headlines as they involve large sums of money and very public competitions for shareholder support (Johnson, Whittington & Scholes, 2011). Takeovers usually seek to quickly increase a company's market share and/or achieve cost-cutting through economies of scale. Although the intentions are valid, it is neither an easy choice nor a natural process. Inorganic growth can be dangerous if the due diligence process is not thoroughly performed as they sacrifice the company sustainability in their hurry to rapidly improve. According to a recent Harvard Business Review (2018), the failure rate for M&A sits between 70 and 90 percent, suggesting the complexity and risks that these transactions face.

The multinational information technology company HP acquired the UK software firm, Autonomy, in 2011 for \$11.1 billion and one year later it wrote down more than \$5 billion because of "serious accounting improprieties, misrepresentation and disclosure failures" practiced by Autonomy (Forbes, 2012). HP justified the high price paid for Autonomy due to the prosperity of the forecasts made with the information that Autonomy provided with to HP. Another example is the case of the magnate Warren Buffett admitting having overpaid for Kraft's merger with Heinz (Financial Times, 2019). Although these two examples have clear differences, both show how overpayment¹ is present in these transactions. Even rational investors as Warren Buffet usually looking for long-term sustainability may fail due to fact that the hard, time-consuming and extremely needed due diligence process are not thoroughly performed.

¹ The majority of people consider that overpayment is just paying a high price. However, overpayment is paying above (i.e. paying for things with no value and that would not imply future benefits for the company).

Inorganic growth through M&As can represent a signal of pressure to show results or pretending to be well performing at once. Such a huge investment, if not appropriate can lead to different drawbacks for the company because of the difficulties that joining two different firms have. The company context, culture, organizational structure... can vary so heavily that the merger can easily end up in a big failure. For instance, as reported in a news from the BBC, the merger between HP and Compaq triggered a loss of 15,000 jobs. The result was a decrease in costs without an increase in profits. In short, that “quick” decision made to please investors and show good performance results, can have very negative consequences for the company in the long-term. This is therefore another example of an attempt to bolster margins focusing just on the cut short outcomes and these decisions are becoming more and more popular in public markets nowadays².

Today successful companies *hoard cash* with purposes other than operational. CNBC (2017) discusses whether having huge amounts of cash is considered a red flag. It suggests that big companies accumulating excess cash can be interpreted as lacking ideas for investment in the long-term performance of the organization. The case of Apple is even harder since not only it accumulates cash (not investing it in further research or in job creation and higher salaries), but it also borrows money which is not precisely used in innovation development (Foorohar, 2016).

Even though all this is licit (each firm can decide how they manage to continue successfully operating) there is no doubt that it is a much riskier strategy because it depends on more volatile aspects than an operational strategy to achieve faster results. What is more, Revelation Investment Research found that in big companies with large amounts of cash, the returns were even worse than those of companies with low amounts of cash on hand (CNBC, 2017). Hence, it can be inferred that a high volume of cash is not necessarily related to good performance. The relevant issue relies on how to use or funnel this excess cash into profitable investments that could help to improve the company in the longer-term.

Outsourcing and other save-costing strategies could be also interpreted as a short-term oriented behavior. Although some defend that outsourcing allows companies to increase their performance by focusing on the things they do best (Quinn,1992), others argue that it might reduce innovation, transfer knowledge to supplier companies and reduce control on firms’

² Money spent on M&A’s represents almost two thirds of the whole amount of R&D spending by American firms (IRI, 2016).

activities, thereby destroying long-run competitive advantage (Bettis, Bradley & Hamel 1992). Outsourcing can therefore lead to a decrease in R&D competitiveness because it is a substitute for innovation.

Much the same with outsourcing strategies, other tactics with the aim of saving costs penalize the long-term performance of the company. An illustrative example of this is the permanent decline in market share value, revenues and assets that Xerox suffered due to a replacement in its top-selling copiers from high-quality material to plastic one (Foroohar, 2016). This example shows how some strategic decisions that might seem adequate at first sight, can have harmful implications for the company sustainability and success. Given that short-term good results can easily become a completely failure in the future, special attention should management place to these settlements.

Accounting plays an important role for understanding the motivations of managers' decisions too. It is a fact that most of the times, long-term oriented investments such as R&D, brand reputation or advertising have a negative impact in the short-term. Due to the great influence that the prudence concept³ exerts in accounting standards (i.e. IFRS and US GAAP) investment efforts are forced to be recognized as an increase in expenses rather than in assets, without an immediate positive consequence in revenues. As an illustration, international accounting rules such as IAS 38, that deals with intangible assets prohibit the capitalization of research expenditures. IAS 38.54 states "Charge all research cost to expense". Besides, IAS 38.57 explains "Development costs are capitalized only after technical and commercial feasibility of the asset for sale or use have been established." As a result of accounting standards, the net income of the company the year those investments are made, is penalized because the vast majority will appear in the company's income statement as expenses rather than as capitalized assets. Therefore, operating results of companies depend greatly on the scope of the decisions being made which at the same time depend on how accounting standards define the accounting rules. H&M gross margin, for instance, decreased to a 58,8 percent in 2014 as a result of broadening its product range and investing more on information technologies (Palepu, 2017)⁴.

³ According to the prudence concept, the amount of revenues recognized should not be overestimated and the amount of expenses should not be underestimated. It implies that companies be conservative in recognizing assets and not underestimate liabilities.

⁴ Nowadays H&M is suffering a lot because of the lack of digital investments. Its current tendency is a decrease in sales since people wants to buy digitally and this company lacks the required inversion (probably because it will affect its short-term results).

As investors are prone to study the performance of the company by considering those indicators and their investing decisions will be made accordingly, managers fear to take risks in that sense. Despite these inconveniences, managers should take into consideration that those investment decisions will result in better results for the company afterwards and they should be able to defend this. At the end, the management team is the one making decisions and they should look for the best to the company and not just for the benefits of some. As the former CEO of Spectris, a company headquartered in UK, says in an interview in the LSE, it is also important to look for shareholders worried about the long-term of a company (LSE, 2019).

In short, there is a tendency not to worry much about the performance of the company in terms of technologies, innovative capacity, social benefit or human capital development but instead to think more on the success of a company in reference to its ability to achieve high share prices and margins at the expense of all the other. This contradicts the idea that companies search for the long-term sustainability of the organization. Still, are all these shortterm oriented procedures applied so as to maximize shareholder value?

3. IT IS SHORT-TERMISM EXCLUSIVE OF THE MARKET?

3.1. Introduction

Private companies invest nearly twice as much as public firms do in long-term investments such as R&D or workers training (Asker, Farre-Mensa & Ljungqvist, 2011). In fact, a research from Stanford University concludes that tech firms reduce innovation in 40 percent after an IPO arguing that once a company becomes public, it focuses on pleasing shareholders alternatively to investing it in the future profitability of the company (Bernsten, 2015). Relevant business people like Ren Zhengfei, the founder and CEO of Huawei, one of the leading companies in the telecommunications industry, argue that the vast majority of Huawei's success comes from the fact that it is a privately-owned company not at the mercy of shareholders; it is free to decide its own vision of the future and act accordingly (BBC, 2019). Contrary to its main rival, Apple, Huawei does not have to pay much attention to short-term financial results and as a consequence, it is one of the five companies that invest more in R&D worldwide.

Following these ideas, we would expect that managers in private companies offered a longterm orientation since they lack the pressure of activist investors. However, short-termism might also be ingrained in the private scene. The lack of market pressure does not

imply that management in private companies might not have incentives towards short-term oriented strategies. There might be some forces that explain why short-termism can affect the private context as it does in publicly-held companies. Here are some instances.

To begin with, even though new compensation schemes like stock options are more of a market thing, they are not exclusive of public companies. In the private scenario it is still possible to pay management based on accounting fundamentals. Managers might be motivated to increase their own compensation and therefore have similar incentives to show good results. When these motivations alter long-run investing decisions, we can consider that short-termism is present in private companies too.

Even though private companies have more restricted access to public debt markets, private firms have leverage ratios that are approximately 50% higher than those of their public counterparts, which is suggestive of the difference in the financing behavior of both groups of companies (Brav, 2009). The leverage of private firms has increased compared to public firms (Medina, 2015) and it consists mostly of borrowing from banks (interest-bearing). One of the usual characteristics of bank debt is the need to meet debt covenants. Despite the fact that covenants are ubiquitous in financial contracts such as public debt, private debt and private equity (Chava & Roberts, 2008), the use of accounting-based covenants in public debt has declined over the last century (Begley & Freedman, 2004).

Following the classic definition of Jensen and Meckling (1976) and Smith and Warner (1979), covenants give incentives to follow a value-maximizing strategy through restriction to managerial behavior. Christensen and Nikolaev (2011) describe two different types of covenants, capital covenant and performance covenant. The most relevant to short-termism are performance covenants, namely, those that require a minimum profitability level since it is likely that they condition managers' profit-related actions.

When debt covenants are about to be reached, managers suffer pressure to increase earnings either to reduce the restrictiveness of accounting-based constraints in debt agreements or to avoid the costs of covenant violations (Beneish, 2001). Dichev and Skinner (2001) find an unusually small number of loans with financial measures just below covenant thresholds and an unusually large number of loans with financial measures at or just above covenant thresholds. This is clear evidence of private firms incurring in short-termist behavior as the mechanisms used to avoid the impending consequences will have a repercussion for the company in the long run. Earning managements practices may sort out short-term problems, but always revert in the future.

Earnings management is usually classified into two categories: accrual-based and real-based earning management. Both try to “mask” the true economic performance of the company but through different means. The former consists of manipulating the discretion given by the accounting standards that are full of estimations and subjective situations. For instance, the recognition of a sale to a customer whose ability to pay is questionable. Even though the company would show higher earnings in that period, at some point in time the corresponding accounts receivables would need to be written off, altering the results and sustainability of the company. On the other hand, real-based management occurs when managers undertake transactions that deviate from the first best practice in order to alter reported earnings. Transactions that were it not for the existence of a debt covenant would have been carried out, are not performed.

Although both could be employed to achieve the covenant thresholds, the second type makes it easier to see how managers adopt decisions without wondering about their longer-term consequences. Examples of real based earning managements include cutting R&D investment or to decrease selling prices with the only purpose of increasing income through sales volume. Both are actions that will sacrifice the future profitability and sustainability of the company.

3.2. A special case in the private context: Private equity (PE)

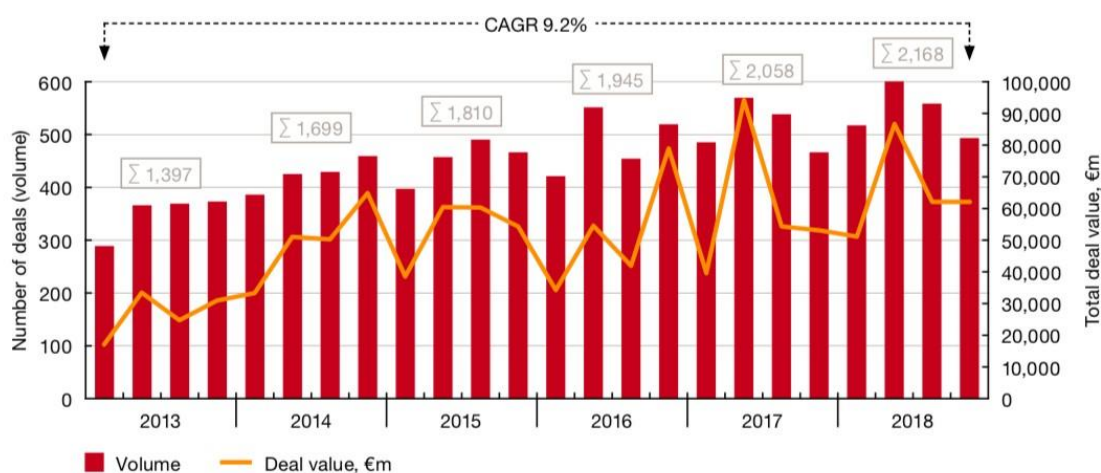
Even though broadly speaking the already presented mechanisms might take place in any private company, there is a case within the private context, the private equity industry, that has been subject of intense criticism for practices like expropriation and short-termism. Private equity firms take companies out of the market to avoid some of the pressures commented in section 2 but the truth is that alternative problems simultaneously arise in the companies they acquire.

Private equity firms, managed by the so-called general partners (GP), raise large pools of capital from institutional investors (Limited partners, LP) who usually and temporarily undertake risky investments with the purpose of obtaining higher than average returns (Appelbaum & Batt, 2014). All decisions are guided and managed by the GPs although their monetary contribution and thus, their risk, is minimal. In general, the LPs are pension funds, wealthy individuals and other institutional investors that are the ones who provide most of the capital although they have little influence in its management (Stringham & Vogel, 2018).

Private equity is particularly relevant due to its increasing importance. A large and growing share of the economy is managed by the private equity industry (Ayash & Schütt, 2016).

European private equity activities have suffered a spectacular increase as shown in Figure 1. A recent study published by the strategic consulting company Bain & Company shows that the capital gained by private equity funds has globally increased from \$299 billion in 2010 to \$527 billion in 2017. In 2018, it has even reached the levels of 2007, where a boom in the private equity industry took place and the expectations for 2019 are higher. In Spain, the quantity amounted to 3,087 million euros in 2017 (Fernández, 2018), that is also above the peak reached in the private equity boom that took place just before the economic crisis.

Figure 1: European Private Equity Trends, 2013-2018



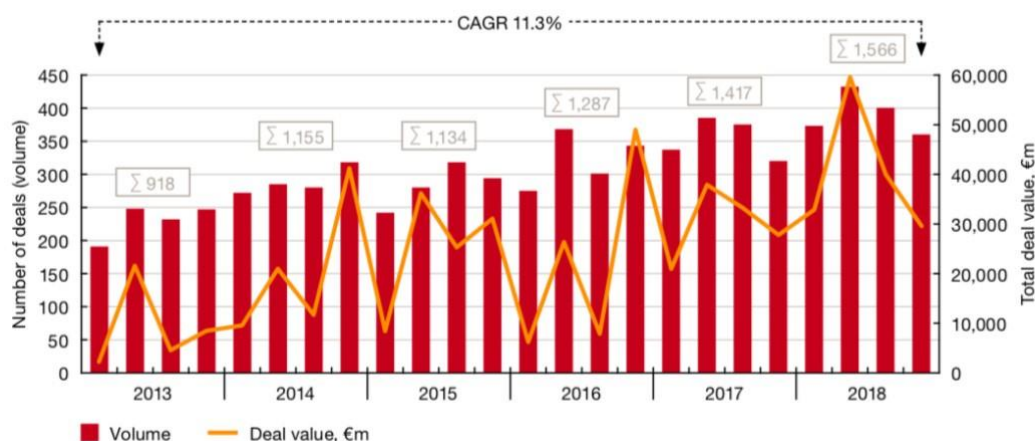
Source: Private Equity Trend Report 2018, PWC.

Most of the private equity acquisitions are done in the form of leveraged buyouts (Appelbaum & Batt, 2014). Even though private equity initially emerged in the form of venture capital, the reality that prevails nowadays is that LBOs funds are first class competitors in big corporative operations. An LBO is a transaction in which a group of private investors use debt financing to purchase a corporation or a corporate division (Palepu, 1990). The acquisition is usually assembled through a special vehicle purpose (SPV) set up for the operation, the repayment of the debt depends exclusively on the cash flows generated by the acquired company and its assets are set as the guarantee that backs up the funding (Fernández, 2018).

LBOs represent the largest share of private equity investments in the European Union (Ughetto, 2010). In Spain, leveraged buyouts represent the greatest fragment of private equity acquisitions. Companies being acquired in an LBO process increased from 8 in 2001 to 35 between 2005 and 2007 on average (Fernández, 2018). Figure 2 shows the trend followed by

European buyouts during the last five-year period. Its increasing presence and the potential sources of short-termism that they imply, make them considerably interesting for the present study.

Figure 2: European Buyout Trends, 2013-2018



Source: Private Equity Trend Report 2018, PWC.

The literature has studied the impact of private equity funds on their acquired companies and most studies defend a positive effect of LBOs on performance, especially in the first wave (from 1980 to 1989). Kaplan (1989) argues that LBOs are actual engines of growth both for small and medium-sized enterprises claiming that the companies experience an operating income and net cash flow increase.

Jensen (1989) argues that LBOs generate economic efficiencies through a superior governance framework (which can better align manager’s incentives to those of investors and shareholders) through high leverage, concentrated ownership and monitoring. Supporters of the LBO model state that the organizational changes connected to this type of transactions strengthen incentives for managers to maximize value to investors and make better investment decisions by cutting back wasteful investment. Baker and Wruck (1989) even claim that these organizational changes avoid or reduce the likelihood that improvements arise at the expense of long-term value.

One of the benefits of a high debt level is that it reduces the “free cash flow” problem. Free cash flow is the cash in excess of that required to fund the projects with positive net present values (Jensen, 1986). When managers have a lot of discretion about how and where to allocate a firm’s cash flow, there is a temptation to use it in projects that do not increase the wealth of shareholders (Bodie, Merton & Cleton, 2012). Commitments to debt payment

bring pressure to improve operational efficiency and eliminate investments that will not be profitable (Bacon, Wright, Meuleman & Scholes, 2012).

Moreover, reductions in post-buyout corporate tax payments are also frequently suggested as a significant source of wealth gains to investors from LBOs through interest tax shields (Palepu, 1990). Tax savings provide a strong incentive for LBOs: by issuing high levels of debt, firms increase their interest tax deductions.

4. SHORT-TERMISM (VS. EXPROPRIATION) IN PRIVATE EQUITY

4.1. Why might PE managers have incentives to incur in short-termism?

PE-owned companies show similarities with publicly-held companies in several ways. Both are under pressure to maximize short-term shareholder value and have an array of financial and organizational strategies to do this (Appelbaum & Batt, 2014). Not only do they have this pressure, but they sometimes pursue their aims more aggressively than public companies at the expense of other stakeholders of the company. Private equity funds are short-term investment vehicles in nature (Ayash, 2018). Managers are forced to generate high fund returns in the shortest possible period. The duration of the investment holding period is therefore crucial to understanding the reasons behind short-termist oriented behaviors in private equity transactions.

The success of private equity investments is mostly measured through the investment rate of return (IRR). Because of the concept of time value of money, most GPs aim to exit their private equity investments as soon as possible. An early exit goes a long way towards explaining superior investment return (Canderle, 2016). Target companies have to be turned around within a couple of years and the main objective of their existence is to deliver returns to their owners. All this will strongly influence the strategies and actions adopted by the managers of these funds.

Large rates of returns are sometimes achieved through quick flips, what Phalippou (2017) describes as briefly held investments, confirming the short horizons that GPs have. The famous quick flip of TH Lee in 1992 stands as an illustration of the excessiveness in the duration and returns of some investments. It bought Snapple for \$135 million and sold it two years later to Quaker Oats for \$1.7 billion (Phalippou, 2017). It is hard to believe that extremely short frames of time allow private equity companies to create the value and to provide the expertise and goodness that they claim.

The own structure of the funds and the compensation methods that characterize the private equity industry also stimulates short-termism. Because LBO funds are created with limited terms of approximately ten years, LBO sponsors must continually make cash distributions to their investors to raise successive investment funds (Ayash, Bartlett & Poulsen, 2017). When professionals raise funds, they are compensated according to a percentage of the money they have under management. However, they only receive that compensation if the money is put to work, that is, if a target company is purchased. Disbursements from the fund are made just as a fund liquidates its investments.

Usually promises are made to the LPs about the timing to invest that money in and therefore, if that time frame goes by, there is a pressure to spend that money in whichever deal. For similar reasons, because commitments are done about the expected time to be holding a company, managers are sometimes pushed to sell their acquired companies almost at any price. This pressure to purchase, but above all the pressure to sell given the limited nature of the funds, could give rise to short-termism.

Another reason why managers incur in short-termism is the pressure of the debt and the resulting change of structure, usually suffered with the LBO, called “structural break” (Ayash & Schütt, 2016). Private equity turns on its head the capital structure of the typical public corporation: the capital structure of a company acquired by a private equity fund is often 70 percent debt and 30 percent equity (Appelbaum & Batt, 2014). The doubled or further multiplied debt LBO companies are loaded up with means that most resources have to be mobilized to pay off this debt. It frequently means that they have to sell off otherwise productive assets or that they are simply left with trouble generating the revenues that are needed to repay this debt. That can force them to ditch long-term strategic imperatives in order to serve their creditors (ITUC, 1997).

Even though an optimal debt ratio is necessary to achieve profitability levels, the trade-off theory (Myers, 1977) predicts that the amount of debt that a firm raises is a balance between the value creation of interest tax shields and the expected cost of financial distress. It is optimal for firms to raise additional debt until the marginal tax shield benefit of the additional dollar of debt equals the marginal increase in expected cost of financial distress (Myers, 1977). It is not certain, however, that the level of debt faced by LBO-acquired companies is in accordance with this theory. The new capital structure after an LBO implies side-effects on long-term performance and sustainability. The controls arising from high leverage and

financial monitoring likely limit managerial discretion and stifle flexibility and risk taking (Ughetto, 2012).

As previously mentioned, one of the arguments for this high leverage levels, is tax saving benefits. An opposite view is that the cost of capital is more or less independent of leverage, since the tax advantage of a high level of debt is almost entirely offset by the higher cost of that debt (Berg & Gottschalg, 2005). Tax benefits do not always compensate the interest burden that the company faces and that prevents it from long-term growth. More serious is the fact that all those tax savings are translated into less contributions to the country's social welfare. The Danish Ministry of Taxation studied the issue for the year 2007 and evidenced that the Danish Government was losing crucial tax revenue due to the tax avoidance of foreign private equity firms (ITUC, 2007).

Naturally, debt covenants are considerably present in private equity loan agreements and following prior rationales, they will also induce to short-termist behaviors. In 2007 private equity backed companies were focusing their strategies in meeting quarterly results due to the need of meeting some debt covenants rather than long-term value creation (Canderle, 2012).

4.2. Actions taken. Short-termism vs. Expropriation

The aforementioned incentives not only induce managers to rely on short-termism, but they also might motivate expropriation strategies. Critics based on the presence of these two strategies and concerned on the potentially negative effects of LBOs (e.g. layoffs, reductions in wages, capital, and R&D investments) emerged among the media, trade unions and certain political sides. Research has also been done in this topic. Cohn, Mills & Towery (2012)'s results appear inconsistent with LBOs improving operating performance, either through the disciplining effects of leverage and concentrated ownership or through operational expertise supplied by private equity acquirers.

In most cases, previous literature has used interchangeably both terms (i.e. short-termism and expropriation), to contradict the official narrative of the private equity industry, because of the difficulty in drawing a line between the expropriation and short-termism scenarios. There is, however, a common concern: in both cases negative long-run effects occur on the acquired firms.

Those who focus on *expropriation* usually refer to private equity managers finding ways of extracting wealth from the companies they take over. Managers frequently take up new loans

to pay out dividends to themselves and engage in other dubious acts to cash in on their new ownership, like charging the companies large consultancy fees or lending out money to their companies at interests well above market rates (ITUC, 2007). Another source of cash is stripping assets. Management fees represent one of the most important focus of criticism, and a clear example of expropriation. The private equity fund managers get an annual management fee of 1-2% plus additional fees for each financial service they provide and when the portfolio company is sold, they assign themselves a percentage of the profit, oftentimes a 20%, known as carried interest. Given that the funds under management run into billions of dollars, these fees easily add up to hundreds of millions (IUF, 2007).

The case of the largest and most famous toy retail company, Toys “R” Us, is an illustration of the consequences that these strategies cause in the acquired company. The group was acquired on July 2005 by an investment group formed by several investment firms and apart from the huge structural break that the firm suffered, the majority of the cash inflows resulting from the closure and sale of some of its stores, were employed in paying excessive management fees.

Those that use the term *short-termism* to criticize private equity firms claim that they have little incentives to please long-term investment opportunities of PE-backed up companies; their rent-seeking behavior and short-term horizon allow them to quickly dismiss the necessary investments as long as the signal exist. Their main intention is to rise the value of the company as soon as possible to successfully exit the company. It is possible that such shortrun performance improvements come at the expense of long-run performance (Harford & Kolasinski, 2014).

In our opinion expropriation and short-termism when applied to the PE case are not synonym terms and although narrow, the border line between them merits discussion. Harford & Kolasinski (2014) even note that the short-termism hypothesis is actually a variant of the wealth transfer hypothesis, indicative of the connection that both strategies might have.

Applied to PE, *short-termism* could also be described as a strategy aimed to feign profitable results achieved through mechanisms that will end up harming the company because they are not sustainable in time. It gives rise to myopic behaviors as managers incurring in shorttermism seek to convince investors and other stakeholders about the goodness of decisions that do not really create long-term value for the acquired company. In short, it means to improve short-term performance trough signaling, allowing for a quick, profitable

exit. Signaling goes beyond cash generation and thus, indicators such as EBITDA are usually enhanced.

With the purpose of achieving the desired levels in operating indicators before the exit takes place, different outcomes such as reducing productive investments and excessive cost-cutting might arise. The excessive levels of debt turn these outcomes (initially optimal) into an urgent necessity. All this leaves companies unable to weather tough times and allows private equity firms to make money even if things go wrong (Canderle, 2016).

Cost-cutting strategies are needed to achieve short-term objectives and to generate the desired signal for EBITDA. They include major cutbacks in investment and employment, decreasing the quality of the materials, subcontracting processes and client neglect, among others. The short-term priorities of PE owners are in conflict with the long-term investments in research, development and other factors that are necessary for ensuring innovation and competitiveness (ITUC, 2007).

Even though *expropriation* will also have long-term negative effects for the company, this strategy is mostly related to cash generation as wealth is typically transferred in the form of cash. It is more focused on benefiting from the engaged actions. When expropriation takes place, “intentional signaling” does not happen since there are no aims in pretending operating performance improvement because concerns over the exit price are much lower. The expropriation channels that PE funds employ during their period of control (e.g. management fees or dividend payments) are enough to benefit from the LBO without the need of selling the company at a very high price⁵. Metrick and Yasuda (2010) found that twothirds of the revenue gained by PE funds had their origin in components that were not sensitive to the performance of the acquired firm. Thus, the majority of the sponsor’s revenues do not depend on the difference between entry and exit price of the target company but on other channels not related to performance-related improvements.

Practices such as cost-cutting or decrease in investments might be also used for expropriation purposes. In contrast with short-termism, the aim behind these decisions is not to hold a signal to maximize the exit price, but to generate as much and as quick cash as possible during the holding period. They seek mechanisms for cash generating which are generally more aggressive than those aiming signaling.

⁵ There are cases in which target firms file for bankruptcy, meaning that no benefits can be earned from the sale of the firm.

5. VALUE CREATION, EXPROPRIATION, SHORT-TERMISM OR GROWTH. AN EMPIRICAL STUDY

The second part of this project presents an empirical analysis in which we study five scenarios that might emerge in private equity-backed companies. The first two scenarios have been already presented and are the *value creation* scenario (Scenario 1) argued by the official narrative (e.g. Jensen 1986) and the *wealth expropriation* scenario claimed by Harford & Kolasinski (2014) (Scenario 2). We separate our view of *short-termism* into two additional scenarios: *signaling* and *exhaustion* (Scenarios 3 and 4) and finally, we consider a fifth scenario which is opposite to short-termism that we refer to as the *growth* scenario (Scenario 5).

When thinking about short-termism different situations can arise. Some would argue that *short-termism* exists when improvements in multiples, ratios and performance in general are achieved during the holding period (i.e. the period in which the private equity firm has been managing the company), but that are not sustainable once the deal finishes. They would only be a signal artificially held until with the purpose of maximizing the exit price. After the exit, it is difficult to assess whether private equity firms have adopted short-term oriented behaviors given that new owners enter that might influence the company's performance.

Either if a secondary buyout, an IPO or a M&A proceeds the deal, the success or failure of the company after the exit cannot be claimed to be just consequence of the PE management. There are no studies evaluating the target companies' accounting-based performance after the LBO. Harford & Kolasinski (2014) test whether the well-documented high returns of PE sponsors result from wealth transfers and short-termism through a pre-post exit analysis, but it is a market-based study⁶. Because of the difficulty in gathering information subsequent to the LBO we limit our analysis in the LBO years (i.e. the study ends up in the exit). This represents the third scenario under study, the *signaling* scenario.

A different vision of short-termism is the one in which the signal is sent but disappears before the end of the holding period. In this case, signaling is also pursued but the actions taken are so short-term oriented that it is too difficult for the target company to hold the created signals until the exit. Therefore, if operational changes arise between the LBO and the exit (e.g. an increase in sales the first years that turns into a decrease or a lower increase since that moment onwards) we could conclude that the measures taken to obtain short-term gains are not

⁶ As an illustration, the market price and EBITDA of the British multinational retailer, Debenhams, immediately drop after the LBO.

enough to keep these results until exit. We refer to this circumstance as *exhaustion* and this is our fourth scenario (Scenario 4).

We consider a final potential scenario, the *growth scenario* (Scenario 5). It is an opposite one to short-termism as efforts are made for the company to grow without no short-term rewards. Decisions that might harm the operating results in the first place but whose ultimate purpose is achieving a sustainable improvement in the performance evolution are preferred. We have left this scenario to the end because the own nature of the PE industry, makes it unlikely that PE funds sacrifice their returns in the benefit of the subsequent owners. Nonetheless, it is a possibility that could arise too, so we need to take it into account.

We test five different hypotheses related to each of the aforementioned scenarios in order to contrast which is the one that actually occurs. The different hypotheses are summarized in Table 1.

Table 1: Hypotheses

Hypothesis 1: A <i>value creation</i> scenario following Jensen (1986) corresponds with the LBOs in the sample.
Hypothesis 2: An <i>expropriation</i> scenario corresponds with the LBOs in the sample.
Hypothesis 3: A <i>signaling</i> scenario corresponds with the LBOs in the sample.
Hypothesis 4: An <i>exhaustion</i> scenario corresponds with the LBOs in the sample.
Hypothesis 5: A <i>growth</i> scenario corresponds with the LBOs in the sample.

Source: Own elaboration. *Notes:* From the five scenarios, just one will not be rejected.

These five scenarios can be studied using the value generation framework of Berg and Gottschalg (2005), which is the result of a variety of value generation levers working together in a complex process. This framework, which follows a Shareholder Value Model perspective focuses on a combination of intrinsic value created and other external factors like multiples or negotiation abilities. Even though the final objective of the framework is shareholder value creation, it allows to discern whether there is also value creation for the target company, and therefore, for its stakeholders.

Intrinsic value is the difference between value creation and value expropriation during the period studied. If we split it up into the three possible functions that contribute to it: operating, financing and strategic, we have the following formula:

$$IV_E - IV_{EN} = VCRE - VEXP = VCRE_{FIN} - VCRE_{FIN} + VCRE_{OP} - VEXP_{OP} \square VCR_{STRAT}$$

Considering the time and amount of detail that carrying out a study on the three different levers would imply, and given that we believe that the operating and strategic functions are

the ones more relevant to discern between the five scenarios is in place, the aforementioned formula is reduced to:

$$VCRE_{OP} - VEXP_{OP} \square VCR_{STRAT}$$

We test the difference between this vision of intrinsic value before and after the LBO considering also the distance in years with the LBO (t_0). Given that our aim is to prove whether which one of the five scenarios aforementioned described prevails, we need to distinguish between the first two years after the LBO (t_1, t_2) and from this point forward (t_3, t_4, t_5).

6. DATA

6.1. Sample description

To analyze the presence of short-termist behavior in LBO transactions we use a dataset created by a research team from the Business Management department of the Public University of Navarre with whom I collaborated in the final phase of the sample data gathering (November 2017- June 2018). The sample consists of a list of 358 LBOs over Spanish firms carried out between 2000 and 2011. It contains detailed accounting information on the acquired companies taken from the SABI database. The sample compiles information for a period ranging from 2 years before the buyout and 5 years post-buyout. Using this unique dataset, we are able to study patterns of a representative sample in Spain.

The sample is divided into three categories considering the trajectory followed once the LBO has taken place. The first one includes cases in which a Special Purpose Vehicle (SPV) entity has not been created ($n=75, 21\%$). An SPV entity was set in 283 cases (80%), 176 of which (49%) were subsequently followed by a forward merger⁷. The second group includes LBO cases in which an SPV entity was set but was not followed by a forward merger. In the remaining cases a forward merger occurs either the very first year after the LBO or later. For analysis purposes, we are going to use the last category (i.e. LBO followed by a forward merger) as it is the most adequate and representative case for understanding the implications of an LBO in the target company.

⁷ A forward merger occurs when a merger process in which the SPV takes over the target company follows the execution of the LBO. Forward mergers are perfect for transferring the aggressive effects of the purchase to the target company.

A control sample has been also constructed for which each target company has been matched up with a firm of similar size and industrial sector that had not been acquired in an LBO. This allows us to see whether the behaviors observed in the targets' sample are specifically driven by the LBO.

6.2. Variable measurement and definition

In choosing with variables to focus on, we started with a baseline study of the data gathered by the private equity literature. A listing of the variables used in the empirical analysis along with its definitions is provided in Table 2; all correspond to accounting-based performance measures. All variables are computed for both the target companies and the control sample.

Table 2: Variables used and their descriptions.

Variables	Definition
EBITDA	Earnings before interest, taxes, depreciation and amortization
Sales	Firms' total sales
Days Accounts Receivables	Days of accounts receivable outstanding
Days Accounts Payables	Days of accounts payable outstanding
Days Inventory	Days of inventory on hand
Tangibles	Firm's total tangibles
Number of employees	Firm's total number of employees
LBO	Dummy variable that is equal to 1 if the firm underwent a buyout; 0 otherwise
POST	Dummy variable that is equal to 1 in the period post LBO; 0 otherwise
BUILDUP	Dummy variable that is equal to 1 if the firm is part of a buildup; 0 otherwise

Source: Own elaboration

Consistent with the aim of studying the five scenarios, the growth rate of these variables is computed on a time window of 7 years around the investment date (t_{-2} ; t_5). This seems reasonable because it allows the evaluation of a firm's performance over a long enough time period after the deal has been made. Year 0 is the year where the LBO is recorded in the financial statements. As firms exit private equity control, they exit the sample.

7. METHODOLOGY

To test the hypotheses under study and to provide new evidence regarding the pattern followed by the variables related to operational and strategic performance of LBOs, we specifically track LBO investment and operational measures from two full years preacquisition to at most five years post-acquisition. However, as cash management is also important, we study the effect of LBO on working capital management too.

Following the value generation framework (Berg & Gottschalg, 2005) and with the purpose of formalizing our tests, we perform the following regression, that compare operational, strategic and working capital management measures of LBO firms with the matched control group:

$$Y_{jt} = \alpha_j + \alpha_0 LBO_{jt} + \alpha_1 POST_{jt} + \beta_1 POST_{jt} * LBO_{jt} + \epsilon_{jt}$$

where j is a firm index, t a time (year) index and Y_{jt} is the performance variable. If firm j is an LBO target, $POST_{jt}$ equals one after the deal and zero before.

We use 7 outcome variables to examine LBOs that include primarily operating performance and profitability measures, investment and working capital management measures. Combined, they allow for a fair presentation of the LBO operating and strategic process. We study and test the effect of LBO on operating performance in contrast with that of those control firms and thus, the most relevant variable for our analysis is β_1 as it provides information on this incremental effect on the control group.

Previous literature has not distinguished the cases in which build-ups⁸ emerge. This can nonetheless bias the results given that the accounting information would be the aggregation of more than two firms and the variables are likely to be higher than in normal circumstances.

Considering the importance of its effects in the final results, we have eliminated those cases from our analysis.

8. EMPIRICAL RESULTS

In this section we present the results of the several tests performed. We run multiple tests with varying post-LBO periods in order to test for robustness of the results. Table 3 Panel A shows the results where POST is a dummy that equals one if periods fall into the postacquisition period and defined as period +1 and period +2 after the LBO and equals

⁸ A build-up strategy is when a company expands its operations by acquiring a platform company and then acquires one or more companies to build out and grow the platform. It is an attractive approach due to the relatively short holding periods employed by private equity.

zero if periods are one or two years before the LBO. Table 3 Panel B shows the results when the post-acquisition period is enlarged to period +4 and Table 3 Panel C when the post-acquisition period comprises the five years (until t_5). In all cases period 0 is omitted. Similarly, Table 4 Panels A, B and C shows the results of the working capital management tests for the different time periods.

Regarding operating performance, we do not find evidence of any post-LBO improvements in EBITDA. We do not find any statistically significant effect of an LBO (see Table 3 Panels A, B and C) and therefore we do not find evidence on signaling purposes through EBITDA in any of the periods. Evidence suggests nevertheless that sales are negatively affected by LBO transactions in 32.9 percentage points the first two years after the LBO (Panel A) and by 33 percentage points in the window between t_2 and t_4 (Panel B).

Even though we do not find statistical evidence of a change in EBITDA, we do it in sales, and therefore we can conclude that LBOs are breaking the degree of operating leverage (DOL) model⁹. The lower increase in the number of employees in comparison with the control group, provides evidence on one of the cost-cutting measures adopted by LBOs that despite the fact that sales are negatively affected, avoids altering EBITDA so badly. We find a statistically significant negative effect of an LBO up to 59.2 % (Panel B) on the number of employees, which is suggestive of the fact that they are sustaining EBITDA thanks to a break in the DOL model.

We have also included tangible assets as a proxy to measure investment tendencies and we find a statistically significant negative effect in tangible assets in any of the regressions that at most reaches 44.5 (Panel A) percentage points. Considering the lack of improvement in operating indicators such as EBITDA in any of the periods studied, we can conclude that Jensen's value creation theory (Scenario 1) is contradicted. By contrast, these results are more consistent with the wealth expropriation hypothesis (Scenario 2), in which the intentions behind the negative effect in investment is just cash generation and not increasing performance, not even as signaling point.

Table 3. Operating and investing performance pre and post-acquisition.

⁹ The DOL measures the sensitiveness of the operating profit (EBITDA, in this case) given a certain variation in sales. It also defines the cost structure chosen by a company at a certain moment in which risk might be introduced through fixed costs that can positively impact the company.

Panel A: (-2, -1) : (+1, +2)

	EBITDA	Sales	Tangible Assets	Number of Employees
LBO	-1.551 [1.679]	1.611 [0.109]	-0.048 [0.134]	0.368*** [0.119]
POST	-1.017 [1.808]	0.544*** [0.118]	0.751*** [0.144]	0.534*** [0.128]
LBOxPOST	-1.386 [2.431]	-0.329** [0.159]	-0.445** [0.194]	-0.484*** [0.194]
Constant	3.935*** [1.156]	9.922*** [0.076]	8.229*** [0.091]	4.711*** [0.082]
LBOs	244	243	244	230
Observations	1,951	1,940	1,951	1,839
R ²	0,15	2,01	1,76	3,39

Panel B: (-2, -1) : (+3, +4)

	EBITDA	Sales	Tangible Assets	Number of Employees
LBO	-1.551 [1.465]	0.161 [0.103]	-0.048 [0.133]	0.368*** [0.119]
POST	-1.056 [1.377]	0.573*** [0.103]	0.754*** [0.125]	0.582*** [0.108]
LBOxPOST	-0.849 [1.848]	-0.330** [0.138]	-0.415** [0.168]	-0.592*** [0.149]
Constant	3.935*** [1.009]	9.922*** [0.076]	8.229*** [0.091]	4.711*** [0.082]
LBOs	233	232	233	222
Observations	2,796	2,784	2,796	2,666
R ²	0,14	2,26	1,77	4,10

Panel C: (-2, -1) : (+3, +4, +5)

	EBITDA	Sales	Tangible Assets	Number of Employees
LBO	-1.551 [3.309]	0.161 [0.109]	-0.048 [0.133]	0.368*** [0.119]

	-1.209	0.581***	0.752***	0.592***
	[2.109]	[0.099]	[0.121]	[0.108]
POST				
	-0.558	-0.322**	-0.408**	-0.499***
	[2.823]	[0.133]	[0.163]	[0.145]
LBOxPOST				
Constant	3.935***	9.922***	8.229***	4.711***
	[1.589]	[0.075]	[0.091]	[0.082]
LBOs	227	226	227	217
Observations	3,171	3,158	3,171	3,038
R ²	0,08	2,23	1,68	4,17

Notes: Estimates are OLS estimates. The variables are defined as follows: EBITDA: EBITDA scaled by tangible assets; Sales: the log of sales; Tangible assets: the log of tangible assets; Number of employees: the log of the number of employees; Asset Turnover: the log of asset turnover. Standard errors for marginal effects are in parentheses and statistical significance is indicated by * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Considering that wealth expropriation consists mostly of funneling cash out of the company and provided that not enough information is available regarding the cash flow statement, we have also studied the working capital management effect of LBOs so as to search for evidence on operating cash generation without a positive EBITDA. The results are shown in Table 4. None of the three variables chosen provides significant statistically evidence on working capital management efficiency relative to controls (Panel A, B and C). We can therefore conclude that private equity-controlled firms do not generate excess operating cash flows through working capital management neither in any of the periods.

Table 4. Working capital management pre and post-acquisition.

Panel A: (-2, -1) : (+1, +2)			
	Days Inventory	Days Accounts Receivable	Days Accounts Payable
LBO	1.156 [183.18]	19.656 [27.12]	-3.542 [10.499]
POST	-7.268 [194.92]	-40.433 [29.18]	4.280 [11.01]

	253.525 [264.58]	51.148 [39.29]	-14.233 [14.91]
LBOxPOST			74.041*** [7.29]
Constant	55.815 [127.55]	144.519*** [18.70]	
LBOs	209	242	210
Observations	1,666	1,936	1,673
R ²	0.17	0.11	0.08

Panel B: (-2, -) : (+3 , +4)
1 Days Inventory

		Days Accounts Receivable	Days Accounts Payable
LBO	1.156 [469.92]	19.656 [48.08]	-3.542 [9.499]
POST	-8.601 [437.61]	-48.84 [45.16]	-1.074 [8.73]
LBOxPOST	557.029 [592.06]	97.85 [60.64]	-12.91 [11.80]
Constant	55.815 [327.22]	144.519*** [33.15]	74.041*** [6.59]
LBOs	199	231	203
Observations	2,383	2,776	2,435
R ²	0.15	0.17	0.17

Panel C: (-2 , -1) : (+3 ,+4 ,+5)

	Days Inventory	Days Accounts Receivable	Days Accounts Payable
LBO	1.156 [441.07]	19.656 [46.49]	-3.542 [9.173]
POST	-8.772 [399.46]	-50.78 [42.47]	-1.914 [8.20]
LBOxPOST	451.64 [538.97]	96.63* [56.88]	-12.69 [11.07]

Constant	55.815 [307.13]	144.519*** [32.06]	74.041*** [6.37]
LBOs	193	225	198
Observations	2,706	3,149	2,774
R ²	0.12	0.18	0.19

Notes: Estimates are OLS estimates. The dependent variables include: Days Inv: days of inventory on hand defined as inventory/sales*365; Days AR: days of accounts receivable outstanding defined as accounts receivable/sales*365; Days AP: days of accounts payables outstanding defined as accounts payable/sales*365. Standard errors for marginal effects are in parentheses and statistical significance is indicated by * p < 0.1, ** p < 0.05, *** p < 0.01.

On the contrary and considering the negative effect on investments, we could conclude that an important mechanism for cash generation is either the disposal of assets or the lower growth in investments. The resulting cash inflows are resources that other companies employ in productive investments and that these others use for expropriation purposes. Even though this gives rise to positive investing cash flow, according to the operating results in which no evidence is found about operating profit margin improvements, Jensen's (1986) theory is again contradicted. The arguments of the official narrative claiming the elimination of inefficient investments to improve operating margins are then refuted. It is then clear that the results are more consistent with wealth expropriation (Scenario 2) than with value creation (Scenario 1), but what about the presence of short-termism?

As described in Section 5 two possibilities can arise when thinking about short-termism. Not evidence is found neither on short-termism in the form of signaling (Scenario 3) or exhaustion (Scenario 4) as not significant changes in EBITDA take place in any of the periods. There are no signs of signaling intentions as no statistical findings arise in any of the periods studied.

Lastly, the growth scenario is not present neither according to these results. Not only does EBITDA not change but investments are also negatively affected and therefore, no evidence is found on negative short-term performance indicators with long-term oriented aims.

In sum, we do not reject the expropriation hypothesis (i.e. Scenario 2) but we do reject the other four, which is suggestive of the wealth expropriation transferred from the acquired firms to the private equity sponsors. There is some evidence however on the limits of expropriation. The negative effects of LBOs on the number of employees and the amount of tangible assets is reduced on year 5 (Table 3 Panel C) in comparison with the two first post-acquisition years, suggesting that these cost-cutting and disinvesting strategies are

exhausted. These are measures that help the company generate cash in the short-term but that once they reach their maximum, they do not serve longer and that harm the company sustainability.

9. CONCLUSIONS

So far, all the purposes contemplated at the beginning have been covered. In this project we have tried to theorize about the concept of short-termism, starting from the market and extending its presence to a financial industry especially related with private firms, the private equity industry.

We have used a comprehensive sample of the financial statements of Spanish private equity buyouts from 2001 to 2011 to test five different scenarios. We have found that in the postacquisition period these firms experience a reduction in sales, assets and employee's growth and we do not find evidence of any post-LBO improvements in EBITDA. With these results we reject four of the hypotheses tested but we do not reject the expropriation scenario, that is, private equity sponsors transfer wealth from the target company for their own benefit. According to our vision of short-termism (i.e. based on signaling), we cannot conclude that they sacrifice long-term in exchange for short-term profits.

No evidence indicates that the mechanisms described by the official narrative (e.g. Jensen (1986)), increase the profitability of the underlying assets. Questioning their contentions, we can think about the need for further regulation in the private equity industry (starting from the Spanish one). The lack of more severe rules could be one of the causes that leads to these adverse outcomes. The social implications are also relevant as the results suggest that few are benefiting at the expense of many. The first step would be to increase the consciousness on how these firms work and what they really do, and this project might shed light in this sense.

There are nonetheless many different topics that are out of this project and would be interesting to review. The analysis could be completed by studying how the financial function affects these results as well as the evolution of target companies' performance after the LBO. At the theoretical level, researchers, and in particular those against the benefits of LBOs, should focus on distinguishing between short-termism and expropriation. During the expounding of this project, we have confirmed our first insights and we conclude that few has been theorized about it. This project questions appealing topics for further research.

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