Management Buy Outs (MBOs)
Entrepreneurial Finance Reading Group

Edo Marchesi

University of Chicago, Booth School of Business

Winter 2022

What is a Management Buyout (MBO)?

Definition

Management buyouts are a form of leveraged buyout in which the management team is part of the investment group buying the firm.

What is a Management Buyout (MBO)?

Definition

Management buyouts are a form of leveraged buyout in which the management team is part of the investment group buying the firm.

Other Participants:

- Equity investors: (1) Buyout specialists, (2) investment banks.
- Lenders: (1) Banks, (2) Institutional investors.

What is a Management Buyout (MBO)?

Definition

Management buyouts are a form of leveraged buyout in which the management team is part of the investment group buying the firm.

Other Participants:

- Equity investors: (1) Buyout specialists, (2) investment banks.
- Lenders: (1) Banks, (2) Institutional investors.

How does financing work?

- Managers and buyout specialists/investment banks put in equity financing (investors' group).
- Usually additional financing is required, so investors group tries to access external debt through: (1) borrowing against firms' existing assets, (2) private placement of subordinate claims.

What is a Management Buyout (MBO)? Cont'd

Acquisition Target

- MBOs can concern the acquisition of both a public and private companies. In the case of public companies, we talk about "going private" transactions.
- Whole company or just a division/line of business can be the target.

What is a Management Buyout (MBO)? Cont'd

Acquisition Target

- MBOs can concern the acquisition of both a public and private companies. In the case of public companies, we talk about "going private" transactions.
- Whole company or just a division/line of business can be the target.

Buyin vs Buyout

Buyin: external management team acquires a company and replaces the existing management.

How do MBOs work?

1. **Pre Announcement:** There might be rumors of managers wanting to take the company private.
2. **Announcement:** Managers announce that they are seeking funding to take company private.
3. **Contracting:** Offer of take-over is presented to shareholders. Creditors are notified. Outside investors may place bids as well.
4. **Resolution:** Shareholders either tender (successful MBO), try to renegotiate (revision of offer) or manage to fend-off acquirers (unsuccessful MBO).
5. **Post MBO:** Reorganization takes place.

Why do we care?

Interesting **Conflicts of Interests:**

- PRE-ANNOUNCEMENT:
  1. Managers have incentives to misreport value of the company (Fischer and Louis (2008), Mao and Renneboog (2015)).
  2. Managers with large equity holding in a company might be inclined to seek funding for buyouts to reduce their dollar amount holding, while keeping their share intact and also be allowed to diversify (Elitzur et al. (1998))

Why do we care?

Interesting **Conflicts of Interests:**

- PRE-ANNOUNCEMENT:
  1. Managers have incentives to misreport value of the company (Fischer and Louis (2008), Mao and Renneboog (2015)).
  2. Managers with large equity holding in a company might be inclined to seek funding for buyouts to reduce their dollar amount holding, while keeping their share intact and also be allowed to diversify (Elitzur et al. (1998))
- CONTRACTING: During contracting process conflicts of interest between managers vs shareholders, managers vs bondholders, managers vs shareholder and bondholders shape the buyout.

Why do we care?

Interesting **Conflicts of Interests:**

- PRE-ANNOUNCEMENT:
  1. Managers have incentives to misreport value of the company (Fischer and Louis (2008), Mao and Renneboog (2015)).
  2. Managers with large equity holding in a company might be inclined to seek funding for buyouts to reduce their dollar amount holding, while keeping their share intact and also be allowed to diversify (Elitzur et al. (1998))
- CONTRACTING: During contracting process conflicts of interest between managers vs shareholders, managers vs bondholders, managers vs shareholder and bondholders shape the buyout.

Solution to **Agency Problems:**

- Full alignment of ownership and control produces efficiency gains from reduced agency costs (Harris, Siegel and Wright (2005); Smart and Waldfogel (2005)).

What do we know so far?

1. **Fischer and Louis (2008):** When managers are planning to propose an MBO (pre-announcement), they face the following problem: (1) depress the company value through misreporting to get more favorable pricing, (2) sustain company value to ensure financing. The first force dominates in the data.

What do we know so far?

1. **Fischer and Louis (2008):** When managers are planning to propose an MBO (pre-announcement), they face the following problem: (1) depress the company value through misreporting to get more favorable pricing, (2) sustain company value to ensure financing. The first force dominates in the data.
2. **Elitzur et al. (1998):** Financial engineering of a buyout is affected by whether management already owner stake in the company. When managers own large stake in company (in dollar amount), they are more inclined to seek external financing to diversify their portfolio of assets.

What do we know so far?

1. **Fischer and Louis (2008):** When managers are planning to propose an MBO (pre-announcement), they face the following problem: (1) depress the company value through misreporting to get more favorable pricing, (2) sustain company value to ensure financing. The first force dominates in the data.
2. **Elitzur et al. (1998):** Financial engineering of a buyout is affected by whether management already owner stake in the company. When managers own large stake in company (in dollar amount), they are more inclined to seek external financing to diversify their portfolio of assets.
3. **Smart and Waldfogel (2005):** Restructuring that follows from MBO produces efficiency gains in the targeted company (although the channel is not clear).

What do we know so far? Cont'd

4. **Solvin et al. (1991):** MBO bids release private information. Bids by incumbent managers have intra-industry valuation effects; companies in the same industry of MBO target experience abnormal returns.

What do we know so far? Cont'd

4. **Solvin et al. (1991):** MBO bids release private information. Bids by incumbent managers have intra-industry valuation effects; companies in the same industry of MBO target experience abnormal returns.
5. **Easterwood et al. 1994:** when competing bids from outsiders are placed, pre-MBO shareholders experience larger returns. MBOs cause a wealth transfer from pre-MBO to post-MBO investors.

What do we know so far? Cont'd

4. **Solvin et al. (1991):** MBO bids release private information. Bids by incumbent managers have intra-industry valuation effects; companies in the same industry of MBO target experience abnormal returns.
5. **Easterwood et al. 1994:** when competing bids from outsiders are placed, pre-MBO shareholders experience larger returns. MBOs cause a wealth transfer from pre-MBO to post-MBO investors.
6. **Kamoto (2017):** post-MBO firms increase investments in innovation, such as new product developments, technological inventions, patenting activity, R&D size and capabilities, and new business creation.

Information Content of MBOs

Previous Work: Solvin et al. (1991)

Going private bids have valuation effects on both the target company and rival companies in the same industry through information release. The find:

1. Announcement of going private:
   - positive and significant effects on target's abnormal returns.
   - positive and significant effects on industry rivals' abnormal returns.
2. Presence of buyout specialist in bid:
   - for target company, abnormal returns are larger when compared to no specialist bid.
   - for industry rivals, abnormal returns are the same when compared to no specialist bid.
3. Bids led by inside management:
   - for target company, abnormal returns are larger when compared to bid started by outside bidder.
   - for industry rivals, abnormal returns are the same when compared to bid led by outside bidder.

Information Content of MBOs

Previous Work: Solvin et al. (1991)

Going private bids have valuation effects on both the target company and rival companies in the same industry through information release. The find:

2. Presence of buyout specialist in bid:
   - for industry rivals, abnormal returns are the same when compared to no specialist bid.
3. Bids led by inside management:
   - for industry rivals, abnormal returns are the same when compared to bid led by outside bidder.

Presence of Buyout Specialist

Solvin et al. (1991) finds that presence of buyout specialist in bid has no intra-industry informational effects.

Potential reasons: definition of buyout specialist/ heterogeneous effects based on specialists' expertise.

Revisit finding conditioning on number of buyouts in which specialist has participated that involve company in the same industry.

Prediction: once we conditioned on measure of "stock of knowledge", we should see that abnormal returns are larger, when compared to bids not involving buyout specialist.

Mechanism: expertise of buyout specialist is observable by the market, therefore investors are able to single out transactions that release industry-level private information.

MBOs and Intra-Industry valuations

Solvin et al. (1991) finds that inside managers leading the bid has no intra-industry informational effects.

Potential reason: managers have diversification incentives (Elitzur et al. (1998)) which the market is aware of.

Revisit finding by studying the relationship between managers' equity holding in the company and abnormal returns for industry rivals.

Prediction: bids led by managers with smaller dollar amount holding have positive and significant intra-industry valuation effects.

Mechanism: investors are aware of diversification incentive and managers' exposure to company's idiosyncratic risk is observable, so the market is able to tell whether the manager is proposing buyout in order to hedge or because company is underpriced and can reap gains.