Discussion of LBO Financing by Mike Burkart, Samuel Lee, and Henrik Petri

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1. Motivation

- How should we view Private Equity and in particular Leveraged Buy Outs (LBOs)?
- In the 1980s, LBOs often involving management played an important role in the restructuring of US industry – many conglomerates were broken up through subsidiaries going private with LBOs
- The firms that underwent LBOs were restructured and started operating more efficiently - often this involved workers losing their jobs and so this process became contentious

1. Motivation (cont.)

- LBO activity has gone through a number of cycles – very active in the early and mid 1980s falling off in the late 1980s and early 1990s then increasing and so on
- Currently there are a number of industries such as retail where there were a wave of LBOs some years ago that have suffered many bankruptcies and the whole issue of allowing LBOs has become contentious, e.g. Appelbaum and Batt (2018, "Private Equity Pillage: Grocery Stores and Workers at Risk") and Elizabeth Warren's *Stop Wall Street Looting Act*

2. Theoretical Background

The paper brings together two important strands of literature to analyse the role of LBOs

1. *Debt as an incentive device:*

In the 1980s two important papers, Grossman and Hart (1982) and Jensen (1986), argued that one of key advantages of debt was that it provided incentives to managers who held equity in the firm to work hard

2. Theoretical Background (cont.)

2. *Debt as way of extracting rents:*

a. Grossman and Hart (1980) pointed to a free rider problem when targets bid for a firm whose shares are widely held

- With no costs of bidding, the only equilibrium is where the target shareholders obtain all the surplus generated by the takeover

- With costs of bidding, the equilibrium involves no takeovers as the bidders cannot recoup this cost

This paper was very influential and led to a large literature on understanding how this free rider problem can be overcome since in practice we do observe many profitable takeovers

2. Theoretical Background (cont.)

2. Debt as way of extracting rents (cont.):

b. Müller and Panunzi (2004) developed an interesting theory showing how takeovers could occur in a Grossman and Hart style model

Starting point is the empirical observation that bidders raise funds by collateralizing target assets – this is called **bootstrapping** in BLP

Bootstrapping dilutes the target shareholders by the amount of debt used by bidders in their bid – the more debt the more rents are shifted to the bidders from the free riding shareholders

2. Theoretical Background (cont.)

2. *Debt as way of extracting rents (cont.):*

Empirical evidence is that gains from takeovers go primarily to target shareholders not bidders so Müller and Panunzi (2004) are successful in solving the Grossman and Hart (1980) free rider problem but not in explaining this fact

3. BLP Theory

What BLP do in this paper is combine the literature on debt as an incentive device in Grossman and Hart (1982)/Jensen (1986) with Müller and Panunzi’s (2004) theory of debt as a rent extraction device to solve the Grossman and Hart (1980) free rider problem

- BLP’s theory can explain why bootstrapping is potentially desirable and matches the empirical data on high debt in LBOs but with target shareholders obtaining large amounts of the surplus

How does it work?

3. BLP Theory (cont.)

- Rent extraction motive of bidder requires that the takeover is leveraged
- This leverage together with the new target managers inside shareholding has the effect of providing incentives to the new target management to work hard so the value of the target increases
- There is an optimal level of leverage that bidders will make to maximise their return while increasing the value of the target through increased managerial effort

3. BLP Theory (cont.)

- High leverage can be Pareto improving and predominantly benefit target shareholders
- Thus BLP can explain why bootstrapping is potentially desirable (at least for initial target shareholders – maybe not for workers and other stakeholders) and explains why LBOs can involve so much debt compared to capital structures in conventional firms

BLP is a very nice paper that contributes to a large set of literatures

4. Comments

1. Another theory of LBO debt involves asymmetric information
   - Raiders (e.g. managers in MBOs) know how to improve the value of the firm and how much it will go up but existing shareholders do not know this
   - In this case the raiders should use debt rather than equity finance so they obtain the gains and do not share them with other people
   - Sufficient frictions should allow this to be modelled
   - Doing this in the BLP framework would potentially provide a theory consistent with the cyclical pattern of LBOs

4. Comments (cont.)

2. Many LBOs involve going private and subsequently becoming public again

- How can this be understood in the model – in this case is effort for restructuring rather than just producing?

3. Why have debt proportions come down relative to the 1980s – can the theory provide insight into this?

4. It would be useful to have a section outlining testable empirical predictions of the model

4. Comments (cont.)

More minor comments:

5. The possibility of multiple equilibria is mentioned in Section 3.2.2 – is this important and what can be said about this issue?
6. Is Proposition 4 structured the best way – isn’t the important result fiercer competition increases debt?
7. It might be worth including some of the examples in the main body of the paper rather than the appendix

5. Concluding Remarks

The paper is an important contribution to many literatures.

It is well worth reading!

6. Reference not included in paper

Grossman, S. and O. Hart (1982). "Corporate Financial Structure and Managerial Incentives." In J. McCall (ed.) *The Economics of Information and Uncertainty*. Chicago: University of Chicago Press.