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The Success of Reverse Leveraged Buyouts

Q&A with: Josh Lerner
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As Hertz approaches what is expected to be a $1 billion "quick flip" IPO just ten months after being acquired, critics are again taking aim at reverse leveraged buyouts and wondering whether investors are being set up for a fall.

RLBOs have come under increasing criticism from the business press and savvy business experts such Warren Buffett. It didn't help when one of the most publicized RLBOs—Refco—collapsed in 2005 shortly after its initial public offering. And on September 21, a 70-million share offering for drug maker Warner Chilcott, taken private in 2004, raised $1.06 billion--but analysts have been disappointed by a share price in the mid-teens.

Are RLBOs really the risky, under-performing investment that is claimed? In fact, says Harvard Business School Professor Josh Lerner, RLBOs generally outperform other initial public offerings and the market as a whole. One exception: So-called quick flips, such as the upcoming Hertz deal, have underperformed the market.

In a new study, Lerner and Boston College's Jerry Cao studied 496 private-equity-led IPOs in the United States between 1980 and 2002. "There had been no systematic scrutiny of the performance of RLBOs since a few studies examining the earliest offerings in the 1980s," says Lerner. "Instead, broad claims are being based on a few highly visible failures, such as Refco, or else analyses of a handful of recent offerings."

Details of a deal

In essence, RLBOs are the offering of new shares in a company or part of a company that had been taken private in an initial leveraged buyout. Usually, buyout specialists will hold their portfolio firms for several years, working with existing management as well as bringing in new managers to improve the firm, Lerner says. After a number of years, the buyout team sells its stakes in these firms.

"This exit can be accomplished through a sale to a strategic buyer, such as a corporation, or to another private equity group. But in many of the most successful investments, private equity groups will take the company in their portfolio public, selling shares to individual and institutional investors," says Lerner.

Critics complain that buyout firms suck out profits rather than improve the firms they acquire, making these companies weakened goods when the IPO is launched. IPO investors suffer when these crippled companies fail in the market.

But when Lerner and Cao started analyzing the actual performance numbers, they saw that conventional wisdom had it wrong. "Reverse LBOs appear to consistently outperform other IPOs and the stock market as a whole. The positive returns appear to be economically and statistically meaningful. Moreover, there is no evidence of a deterioration of returns over time, despite the growth of the buyout market: RLBOs performed strongly in the late 1980s, the mid-1990s, and the 2000s."

For example, RLBOs created a raw buy-and-hold return of 18.25 percent over one year, 43.83 percent over three years, and 72.27 percent over five years after the IPO, the study finds.

Also, the most successful performances were associated with larger RLBOs, as well as offerings by larger groups, "again inconsistent with many of the claims in the press."

Because of the general skepticism in the air, Lerner initially found the results surprising. But not for long. "When you consider why so many initial public offerings do poorly, much of the failure is due to the poor preparation of many firms prior to going public. They simply do not have the systems in place to address the demands of being a public firm: for instance, financial reporting, investor relations, and strategic planning."

Private equity groups, meanwhile, demand that their portfolio companies have good systems in place. "Effective private equity groups create well-functioning private firms, which can then succeed in the public market," Lerner says.

Not all RLBOs are golden. So-called quick flips—when a private equity firm sells off an investment within a year after acquisition—are underperformers compared to other IPOs and the market at large. The analysis found flips underperformed the S&P 500 by 5 percent in the following three years.

Lerner believes that problems with quick flips occur because of the short period that private equity groups have to work with these firms. "While I cannot prove this, my suspicion is that in many cases, the groups are less effective in reshaping the processes and systems of these companies, stemming largely from the fact that they have worked with management for so much shorter a period. It is as if you took your dog to obedience school for one lesson, and expected him to do all sorts of tricks!"

Although the study ended in 2002—the researchers wanted to have at least three years' worth of performance data for each deal—Lerner believes RLBOs continue to create value for investors. He points to the fact that these offerings have done well across many market cycles, and that RLBOs by larger private equity groups have done particularly well.

Thinking about private equity

Lerner is planning a conference under the aegis of the National Bureau of Economic Research to bring together a number of researchers and scholars who have been thinking intensively about the private equity industry.

"This event will examine the changing structure of the private equity industry and the implications of the buyout wave of the past few years. It is clear that this industry is playing a vital role in shaping the economies of the United States and Europe, and increasingly elsewhere as well. This gathering should help us understand these important changes in a more systemic manner."

About 42 percent of all IPOs this year have been private-equity-backed, according to Dealogic, down from 53 percent in 2005. One possible reason for the decline, according to the firm, is that private-equity firms may be selling a higher percentage of their acquisitions to other private-equity firms, rather than facing the uncertainties of an IPO.

About the author

Sean Silverthorne is editor of *HBS Working Knowledge*.

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