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STRATEGIC REDIRECTION IN LARGE MANAGEMENT BUYOUTS: THE EVIDENCE FROM POST-BUYOUT RESTRUCTURING ACTIVITY

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This study examines the nature of post-transaction restructuring activities for 32 large U.S. corporations that underwent management buyouts between 1983–89. This study (i) provides evidence on the extent and type of divestment and acquisition activities under private ownership; (ii) documents the outcomes associated with MBOs and the longevity of the buyout organization; and (iii) investigates the claim that buyouts are primarily mechanisms for breaking up public corporations and selling the pieces to related acquirers. The balance of the evidence indicates that restoring strategic focus is an essential function of the buyout for these large firms. However, the evidence also indicates that the buyout organization does continue to operate significant parts of the prebuyout firm. By far the majority of firms continue to meet their debt obligations satisfactorily during the buyout phase. Finally, the evidence indicates that asset sales to related acquirers derive more from efficiency considerations than market power.

INTRODUCTION

The decade of the 1980s has witnessed a dramatic increase in the incidence of debt-laden corporate restructurings. One form of restructuring that frequently has been employed is the management buyout. In these transactions, the firm converts from public stock ownership to private ownership and the transaction is financed with large debt issues. Stock ownership is concentrated in the hands of incumbent top level managers and a comparatively small number of investors which often includes a 'buyout specialist' who organizes the transaction. In the post-transaction phase, the revised ownership structure and capital structure have significant implications for the motivations of the key groups of stakeholders in the firm, and thereby for the key objectives of the company. These revised corporate objectives in turn are expected to have important consequences for the strategic and operating decisions of the firm, resulting in changes in its asset structure and organization structure. However, the ultimate consequences of these changes are the subject of hot debate.

Such takeovers and their accompanying structural changes are alternately hailed as fundamentally realigning incentives and improving corporate performance or decried as disemboweling America's corporate sector and transferring wealth to the participants in the takeover or pretakeover public shareholders. Advocates of restructuring contend that targets of restructuring are inefficient users of scarce resources that can be improved by replacing the standard publicly owned corporate organization form with an incentive-intensive organization. Prior to the transaction, managerial and shareholder interests may be in conflict. In contrast, the structure of equity ownership of the post-buyout firm is designed to produce coincident interests for the

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various stakeholder groups, towards maximizing the value of the firm. The high levels of debt act as a powerful incentive for managers to strive for high levels of cash generation, to facilitate debt coverage and ward off bankruptcy. In this view, the changes in ownership and capital structure are the basis for creating competitive advantage and building value. Managers are strongly motivated to retain and invest in businesses which build on distinctive competence. They also have strong incentives to divest businesses which show remote prospects for building competitive advantage, and to sell assets that other firms or individuals can use more efficiently.[1]

Critics of the new organizational forms and the restructuring process contend that restructuring damages the firm, its stakeholders and the economy through five channels. First, managers are forced to unload valuable assets at less than their value to the firm in order to service the heavy debt loads restructuring imposes on them. This view may be termed a 'fire sale' hypothesis. Note that sale of assets motivated by the need to raise cash for debt service will adversely affect the competitive position of the restructuring firm only if the market for those assets is not competitive or the seller is the highest valued user of those assets. Second, post-buyout firms do not have access to public equity markets and could be forced to forego profitable investment opportunities. Third, the heavy debt load imposes costs of inflexibility and hinders the buyout firm's responsiveness to competition and change (Rappaport, 1990). The firm's ability to withstand prolonged or extreme conditions of economic adversity is reduced, increasing the probability of costly bankruptcy and reorganization. Fourth, the restructuring process can transfer wealth from employees, bondholders and other corporate stakeholders. Fifth, buyouts may reallocate resources in a manner that increases market power.

Clearly, the buyout organization form has both advantages and disadvantages. The key unresolved issues in the debate center around the relative magnitude of these advantages and disadvantages. This study will address three questions and bring new evidence to bear on the debate.

1. The study will examine the strategic rationale for divestiture and acquisition decisions. An analysis of the assets that the post-buyout firm elects to acquire and divest directly addresses many of the arguments advanced as rationales for management buyouts and other forms of debt-financed restructuring.
2. The study will also examine the economic viability of the new organizational forms as operators of firms and dealers in divested assets. The study will examine the current ownership status, lifetime, and payment record on debt as rough indicators of performance in these areas.
3. The study will also investigate the view that divestment programs result in shifting ownership of assets to the pre-buyout firm's competitors and thus increase economic power, rather than leading to enhanced operational efficiency by the same owners.

Previous research regarding the consequences of leveraged buyouts has focused on operational performance issues (see Palepu, 1990, for a review). However, there is little existing evidence regarding the strategic changes which restructuring achieves, the focus of study in this paper. Our analysis focuses on large management buyouts for which substantial strategic redirection is possible. Our research has important public policy and managerial implications for corporate restructuring, in that it presents evidence regarding important factors which underlie this issue.

SAMPLE SELECTION AND CHARACTERISTICS

The initial list of firms selected for possible inclusion in the sample was generated using the following process.

(i) the *Wall Street Journal Index* was searched for the years 1983–88 under the topics 'Going private' and 'Mergers and Acquisitions' and under the name of seven well-known buyout specialists for firms that received management buyout proposals;

[1] For additional discussion, see Easterwood, Seth and Singer (1989), Jensen (1988, 1989), Kaplan (1989b), and Singh (1990).

(ii) *Mergers & Acquisitions* list of completed transactions and selected issues of W. T. Grimm's *Mergerstat Review* were searched for management buyouts in the same time period;
(iii) the resulting sample was compared to that of Lehn and Poulsen (1989) for transactions that were overlooked by the above procedures.

Finally, to qualify for inclusion in the sample, we imposed the following restrictions: (a) the management buyout proposal successfully took the firm private, (b) the pre-buyout firm was listed on the New York or American Stock Exchange, and (c) the pre-buyout target firm must have had an equity value of $500 million. The final sample is composed of 32 firms.

Management participation varied widely among the sample. In some cases, management initiated the proposal and owned all or almost all of the post-buyout equity. In other cases, a buyout specialist initiated the proposal and included some or all incumbent managers as part owners of the post-buyout firms. In addition, some buyouts included significant equity participation by employees through employee stock ownership plans (ESOPs), while others limited equity ownership to only the top level of incumbent managers.

The exchange listing and size screens were imposed to limit the sample to post-buyout firms which were likely to have substantial strategic restructuring and which could be reasonably tracked through time using public data sources. Under the assumption of a positive association between firm size and product–market diversification, our sample of large firms is particularly appropriate for an investigation of strategic refocusing. Furthermore, inclusion of smaller firms would significantly increase the possibility that important activities were omitted from our analysis because it was not reported by the business media. The pre-buyout size of the sample ranged from a low of $517.8 million to a high of $4.2 billion. The average pre-buyout equity value was $1.38 billion.

In Table 1, we compare our sample with the general incidence of successful MBOs over the same time period. The data for the size distribution of MBOs and aggregate market values was provided by Easterwood, Singer, and Lang (1991). As indicated in the table, the dollar value of the 32 firms with preoffer market values of ⩾ $500 million (which correspond to the firms in our sample) represents 75 percent of the total value of MBOs. This suggests that our sample includes most transactions of major economic significance over the time period we consider. Our results are expected to generalize rather well to other buyouts of large firms. However, our results may not extend to buyouts of small firms whose businesses are narrowly focused or to divisional buyouts.

In addition to the eventually successful management buyout proposal, about two-thirds of the firms also were the targets of other takeover activity. Thirteen of the 32 sample firms received hostile offers from outside acquirers. Six other firms were the subject of takeover rumors, experienced a large stake acquisition, or engaged in overt defensive tactics like paying greenmail prior to the initiation of the buyout proposal. These 19 firms may have pursued the management buyout in part as a means of escaping a hostile threat. No prior or competing takeover activity could be detected using public data sources for the remaining 13 firms.

Table 2 presents the industry composition of the sample by the primary line of business when one can be identified.[2] Nine of the 32 firms (28%) were involved in retailing. These nine were composed of three firms whose primary area was grocery stores, two firms whose primary area was drug stores, two firms whose primary area was general merchandising, one firm whose primary area was convenience stores, and one firm that operated a chain of home improvement stores. Five firms (16%) were diversified conglomerates, with no identifiable core business. Four firms (12%) in the sample were in the communications and entertainment industry. Each of these four firms owned cable television franchises, among other businesses.

Jensen (1986) predicts that firms in industries with large cash flows but low intraindustry growth opportunities are good candidates for leveraged buyouts. In such industries, he suggests, the

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[2] Firms are reported as 'diversified' in this table only in those cases where a primary line of business could not be easily determined. Firms with unrelated divisions, but an identifiable core business, were classified according to that core.

Table 1. Comparison of sample firms with the general incidence of management buyouts

Year of buyout announcement	Pre-offer market value size categories in millions of dollars[a] <100	100–250	250–500	≥500 (sample firms)	Total	Aggregate pre-offer market value of buyout targets in millions of dollars[b] Sample firms	All firms
1983	12 (63%)	2 (10%)	3 (16%)	2 (11%)	19 (100%)	1354 (44%)	3091 (100%)
1984	9 (41%)	4 (18%)	6 (27%)	3 (14%)	22 (100%)	1683 (33%)	5067 (100%)
1985	4 (23%)	2 (12%)	3 (18%)	8 (47%)	17 (100%)	12149 (91%)	13366 (100%)
1986	4 (19%)	6 (28%)	5 (24%)	6 (29%)	21 (100%)	9085 (66%)	13830 (100%)
1987	5 (26%)	7 (37%)	0 (0%)	7 (37%)	19 (100%)	9809 (87%)	11260 (100%)
1988	0 (0%)	5 (33%)	4 (27%)	6 (40%)	15 (100%)	8215 (83%)	9889 (100%)
Total	34 (30%)	26 (23%)	21 (19%)	32 (28%)	113 (100%)	42295 (75%)	56503 (100%)

[a]Cell entries contain the number and percentage of firms in the size categories (percentages are of row totals).
[b]Percentages are of the aggregate pre-offer market value of all MBOs (from Easterwood *et al.*, 1991) for the year.

Table 2. Industry composition by primary line of business

Frequency	Core industry
9	Retailing
5	Diversified
4	Communications and entertainment
3	Glass and paper products
3	Construction materials and services
2	Textiles and apparel
2	Food services and restaurants
2	Hospitals and health care
1	Tires
1	Publishing

benefits from the control function of debt are likely to be high. Jensen specifically cites the oil, tobacco, forest products, food and broadcasting industries as likely to satisfy these characteristics. Noticeably absent from our sample are firms whose primary business area is oil or tobacco, while the other industries are well represented. It is useful to note that the control function of debt may be achieved by mechanisms other than an MBO. The examples cited by Jensen of oil firms undergoing restructuring are leveraged recapitalizations. In a leveraged recapitalization, some proportion of the firm's equity remains publicly held, but the capital structure of the firm is drastically altered with substantial increases in debt. It is possible that the going-private additional feature of the leveraged buyout (as compared to the leveraged recapitalization) is ill suited to the particular characteristics of the oil industry.

Data and methodology

The sample of 32 completed buyouts was followed in the post-buyout phase to determine what strategic decisions the firm made under private ownership. The firms were followed in the *Wall Street Journal, Moody's Manuals*, and the publications whose articles are listed in the *Business Periodicals Index, Business Dateline*, and *DATEXT* as available. Missing details and conflicting information were resolved by contacting representatives of the relevant firms when possible. The firms were tracked from initiation of the buyout proposal until the earliest of the date the firm returned to public ownership, the date it ceased to exist, or December 31, 1991.

Announcement of the buyout proposal, rather than completion, was chosen as the starting point because firms will sometimes divest assets prior to conversion to private ownership for financial or tax reasons. When a division of the post-buyout firm or the remaining assets of the firm as a group were sold, we ceased to follow those assets regardless of the ownership status of the purchaser (i.e., privately vs. publicly owned). This approach was chosen because the emphasis of this study is on the entity that acquires a public firm and converts it to private ownership. Decisions made by subsequent owners of those assets are irrelevant for the present purposes. Event histories containing quantitative as well as qualitative evidence were compiled of the restructuring activities of the firms in the sample. Brief summaries of these event histories are presented in the Appendix.

The methodological approach in this study is one of triangulation, combining qualitative and quantitative methods to arrive at a fuller understanding of the phenomenon under study. As pointed out by Jick (1979),

> (Triangulation) can capture a more complete, holistic, and contextual portrayal of the unit(s) under study . . . It is here that qualitative methods, in particular, can play an especially prominent role by eliciting data and suggesting conclusions to which other methods may be blind (p. 603).

In analyzing the post-buyout strategies of MBO firms, we use an approach which derives from Mintzberg's definition of strategy as 'a pattern in a stream of decisions' (1978: 935). Thus, we examine the sequence of major resource allocation decisions, in particular the divestment decisions, of the buyout firms over the post-buyout period. Our study responds to the need for longitudinal approaches to more fully understand the complex phenomenon of corporate restructuring.

THE RATIONALE FOR MBOs: EFFICIENCY AND STRATEGIC REFOCUSING

Studies by Singh (1990), Kaplan (1989a, b) and Muscarella and Vetsuypens (1990) document the impact of management buyouts on ownership and capital structure, corporate tax liabilities, accounting-based measures of operating efficiency and profitability, employment, and capital expenditures. The balance of the evidence from these studies indicates that buyouts lead to improved operating performance and reductions in corporate taxes. While these studies provide important evidence regarding the operational efficiency of the post-buyout firms in their samples, they do not address the issue of changes in corporate strategy in detail. There is some limited evidence that, while divestiture of some assets occurs for many of the firms in their samples, substantial break-ups appear to be uncommon. These results suggest that the underlying ailment being cured by the MBO organizational form is one associated with operational inefficiencies rather than of over-diversification.

Bhagat, Shleifer, and Vishny (BSV) focus more specifically on asset divestitute for a sample of targets of hostile takeovers. They find that hostile takeovers are primarily vehicles for breaking firms up into component pieces which are sold off to the highest bidder. BSV interpret their results as indicating that the new organizational forms are temporary and serve only to provide incentives for a quick breakup of the target firm. Specifically, they suggest that 'the role of the raiders and MBO boutiques seems largely to take diversified firms, bust them up and sell the divisions to other firms in the same business' (1990: 44).

However, it is unclear exactly how BSV's evidence warrants this conclusion. In the first place, the precise definition of the term 'bustup' is elusive. BSV appear to use this term to include those firms in which the proceeds from selloffs amount to at least 50 percent of the purchase price. However, they do not account for the businesses which are retained by the MBO firm. By their definition, the Safeway MBO would be categorized as a bustup, even though there remained (and returned to public ownership) a sizeable independent organization whose major assets were clearly a subset of those of the original Safeway that went private. In contrast, we use the term 'bustup' to include only those firms whose assets are completely dismantled and/or change ownership in more than one transaction. Second, BSV do not analyze the actual diversification pattern of their target firms in a systematic manner in either the pre- or the post-buyout phase.

These studies offer contradictory evidence on the viability of the debt-laden firm as a going concern and on the motivation for these forms of restructuring. These contradictory results may be driven in part by the methodology and samples used by these authors. These studies of the vehicle for restructuring the firm have varied substantially in their sample composition. Kaplan (1989a, b) utilizes a sample of 76 management buyouts of whole firms that occurred between 1979 and 1985 and had a purchase price of at least $50 million. Singh (1990) and Muscarella and Vetsuypens (1990) use samples of 55 firms and 72 firms respectively that went through reverse-leveraged buyouts (i.e., public firms that went private and later returned public). These samples include many divisional buyouts and smaller firms. The samples of reverse-leveraged buyout firms may contain a 'success' bias towards firms that successfully restructured and therefore may not be representative of buyouts in general (Long and Ravenscraft, 1989).

In contrast, BSV use a sample of 62 hostile takeover targets between 1984 and 1986 with transaction values greater than $50 million. Their sample includes firms that were acquired by a hostile bidder, firms that were acquired by a white knight, firms that undertook defensive restructuring, and firms that remained independent. Because different motivations are likely to underlie these different types of transactions, it is unclear what the implications of the results are for the specific types of restructurings which are of interest in this study.

Pre- and postbuyout diversification strategies

On an *a priori* theoretical basis there is reason to believe that one primary function of the MBO organizational form is to bring about changes in the asset composition of the firm, i.e., change its corporate strategy, towards building its economic value. It is also true that high debt levels often necessitate asset sales. However, this is not equivalent to predicting that the primary target of MBOs should be conglomerates, as BSV suggest. Their line of reasoning would imply that overdiversification drives MBOs. While this may be one specific type of problem which an MBO may correct, there is no reason to believe it is the only or even the major source of efficiencies associated with the MBO.

However, the pre-buyout diversification strategy pursued by the firm may influence post-buyout strategic decisions. Consider the pre-buyout firm as possessing a number of businesses. Firms differ in terms of the number of different businesses they possess (the degree of diversification) and the separability of the different businesses (the type of diversification; see Rumelt, 1974). To the extent that any pair of businesses share common resources and capabilities, the firm will be constrained from selling assets associated with one business because of the negative consequences of the divestiture for the related business. In other words, if there are significant economies of scope which drive the firm's pre-buyout diversification strategy, efficiency considerations will preclude major changes to the strategy. On the other hand, in the absence of significant economies of scope and with significant pressures to pay down debt, highly diversified firms are expected to alter their strategic position towards greater focus.

The role of the buyout specialist

Twenty of the firms in our sample underwent the MBO with the assistance of a buyout specialist. Some well known buyout specialists include Kohlberg Kravis Roberts & Co. (KKR), Forstmann Little, Clayton & Dubilier, Kelso & Co., and Merrill Lynch. A buyout specialist derives the ability to be in the MBO business from the buyout fund it raises. This fund is used to finance equity purchases in the buyout target. These buyout specialists are important stakeholders in the post-buyout firm, by virtue of their equity ownership and their control over the fund used to finance the buyout. They have strong monetary and nonmonetary stakes associated with the success of the post-buyout firm (see Easterwood, Seth and Singer (1989) for a more detailed discussion of these incentives). The remaining 12 firms in the sample underwent the MBO without the participation of a buyout specialist (the 'independent' MBOs). These firms arranged the financing of the buyout independently.

A question of interest is whether there is a systematic difference between the typical characteristics of specialist-associated MBO targets and independent MBO targets. In a 1989 paper, 'Presentation on Leveraged Buyouts,' KKR lists the following criteria for selection of buyout candidates: (i) a history of demonstrated profitability, (ii) strong, predictable and stable cash flows and (iii) readily separable assets or businesses for sale, if necessary. Both types of targets (specialist-associated and independent) are likely to require the characteristic of large, stable cash flows in order to fulfil the high level of debt service obligations of the post-buyout firms. However, one possible difference between these two groups is the relative emphasis on the separability of the target's businesses. The KKR statement suggests that the pre-buyout diversification strategy is an important consideration in selecting buyout targets; however, this may not be the case for 'independent' buyouts.

Diversification types and hypotheses

To address these questions, we classified the firms in our sample into various diversification strategy types. Each firm's diversity type was classified for the pre-buyout period as follows:

1. Single business;
2. Related business: some common skills or resource are shared by the different businesses;
3. Unrelated business: the firm engages in two distinct and unrelated lines of business;
4. Conglomerate: the firm engages in more than two unrelated lines of business.

This classification scheme is derived from Rumelt's (1974) typology. In classifying firms, we first obtained a listing of the identifiable businesses of the firm as well as the relative importance of the different lines of business to the firm's overall operations. We used company descriptions of their business activities along with (where available) sales data by different lines of business. The next step was to analyze the type of linkage between the different lines of business to judge whether groups of businesses within a firm were related or not. In judging relatedness, we examined whether the different lines of business shared common assets or resources such as distribution channels, purchasing economies of scale, and technology. While we used the SIC code of the businesses for assistance with judging relatedness, this was supplemented by the judgement of the researchers.[3] The classifications were made by each of the researchers independently and cross-validated. In the special case of the retailers in the sample, an industry expert was consulted for assistance with the classification.

All firms which continued to operate independently in either private or public ownership as of December 1991 were also assigned to a post-buyout diversification strategy type in the same manner as followed for the pre-buyout classification. This classification is as of December 1991 or the date the firm returns to public ownership, whichever was earlier.

Our first three hypotheses are as follows:

H1: There is no difference between the relative incidence of conglomerates and unrelated–diversified firms compared to single business and related–diversified firms which undertake MBOs.

H2: The magnitude of strategic focus achieved in the post-buyout period by conglomerates and unrelated–diversified firms is greater than for related and single business firms.

H3: The incidence of buyout specialist participation is greater for conglomerates and unrelated–diversified firms compared to single business and related–diversified firms which undertake MBOs.

Due to sample size considerations, the single business/related diversification categories and unrelated/conglomerate categories are combined for the purposes of conducting statistical tests to investigate these hypotheses.

Results

Table 3 reports the initial diversification strategy of the firms in the sample compared with the post-buyout strategy. As the last column of the table indicates, 14 firms followed a single business/related diversification strategy in the

[3] Following Palepu (1985), businesses which fall into the same two-digit SIC group are typically treated as related. By this rule, manufacture of aircraft (SIC code: 3721) and the manufacture of railway equipment (SIC code: 3743) would be treated as related businesses. However, manufacture of railcars and leasing of railcars (SIC code: 4743) would be unrelated businesses. From a perspective of understanding strategic relatedness, both these rule-based classifications are incorrect. We used our judgement to reclassify all such pairs of businesses.

Table 3. Pre- and post-buyout diversification type

Pre-buyout diversification type	Post-buyout diversification type: Single line of business	Related diversity	Unrelated diversity	Conglomerate	Bustup	Total
Single business	1[a]	1	0	0	0	2
Related diversity	3	7[a]	0	0	2	12
Unrelated diversity	3	4	1[a]	0	1	9
Conglomerate	0	1	3	3[a]	2	9
Total	7	13	4	3	5	32

Cell entries refer to the number of firms in the categories.
[a]These represent the number of firms in each prebuyout diversity category who stayed in the same diversity category in the post-buyout period. Cell entries below these represent the number of firms in each pre-buyout diversity class who focused their activities. Cell entries above represent the number of firms who increased the scope of their activities.

pre-buyout period, whereas 18 firms followed an unrelated–diversification/conglomerate strategy. A binomial test to ascertain whether the probability that the MBO firm follows a conglomerate or unrelated diversification strategy in the pre-buyout period is the same as the probability that the firm follows a single or related diversification strategy supports the null hypothesis of no difference (z-statistic = 0.71). Thus, our results are inconsistent with BSV's contention that highly diversified firms are the primary targets of MBOs. There is an approximately equal incidence of both less diversified as well as highly diversified firms in our sample.

Table 3 indicates that of the total of 32 firms, only five are complete bustups, i.e., all assets of the firm were sold in a number of transactions to public or private buyers. Two of these were related–diversified, one unrelated and two were conglomerates.[4] Of the remaining firms, the table indicates that 12 firms stayed in the same diversification class in the post-buyout period compared with the pre-buyout period. Of these, eight firms followed a single business or related–diversification strategy in the prebuyout period, and four were unrelated–diversified firms or conglomerates. A total of 14 firms considerably focused their activities, i.e., moved from a higher to a lower diversification type, including three related-diversified firms and 11 conglomerate/unrelated–diversified firms. One firm in the sample, Macy's, moved in the opposite direction. Macy's was classified as a single-business firm (department store retailing) in the pre-buyout period. In the post-buyout period, it considerably expanded its specialty store retailing operations and accordingly was classified as a related–diversified firm. A chi-square test result ($\chi^2 = 3.72$, df = 1, one-tailed test, $p < 0.05$) suggests that the data are consistent with the hypothesis that conglomerates and unrelated–diversified firms do in fact achieve greater focus in the range of businesses they engage in than do single or related–diversified firms, as we expected.[5]

Table 4 reports the frequencies for Hypothesis 3. Again, the data ($\chi^2 = 2.74$, df = 1, one-tailed test, $p < 0.05$) are consistent with the hypothesis that buyouts led by specialists are more highly diversified than 'independent' MBOs. All five of the MBOs which underwent bustups had buyout specialist participation. Fifteen of the specialist-associated MBOs continued to operate some of the original businesses of the pre-buyout firm. Overall, there are important differences between the underlying motivation and the associated strategic redirection of specialist-associated and 'independent' MBOs. However, these differences appear to be less extreme than BSV suggest.

[4] In this table, we make no distinction between unrelated–diversified firms and conglomerates with and without identifiable core businesses, as was done in Table 2. Here the purpose is to describe the diversification strategy of the firm, rather than to identify primary industry affiliation.

[5] Combining the single business/related diversity categories, and the unrelated diversity/conglomerate categories in both the pre- and post-buyout phases produces a 2 × 2 contingency table. This contingency table is the basis for the chi-square test.

Table 4. The relationship between pre-buyout diversification type and participation by a buyout specialist

	Pre-buyout diversification type		
MBO type	Single line of business and related diversity	Unrelated diversity and conglomerate	Total
Independent	8	4	12
Specialist	6	14	20
Total	14	18	32

Cell entries refer to the number of firms in the categories.

Divestment strategies in the post-buyout period

The analysis thus far summarizes the changes in corporate strategy achieved by large MBO firms. To further understand how the buyout firms achieved these changes, a more detailed analysis of the specific types of divestment strategies followed by the firms in our sample was conducted. The typology constructed for divestment strategy mirrors the growth strategy typologies proposed by Ansoff (1968), as follows:

1. No identifiable divestiture activity occurred in the post-buyout period;
2. Market focus strategy (restructuring activity consists of reduction of geographical coverage);
3. Business focus strategy (lines of business sold which are related to those retained);
4. Corporate focus strategy (lines of business sold which are unrelated to those retained).

Each identifiable divestment decision for each firm was classified into one of these types, and the overall pattern of divestment strategy identified. As an example, consider American Standard. This conglomerate divested its rail braking, railway switch and signal, metal doors and frames and a portion of its refrigeration businesses in the post-buyout period in five identifiable transactions. The firm, as of the end of 1991, continues to produce automotive braking equipment, air-conditioning and refrigeration products, and building products. The railway equipment transactions were each classified as corporate focus strategies, since as a consequence of these transactions the firm exited these related lines of business altogether. The latter two divestitures were classified as business focus strategies, since American Standard continues to operate in related lines of business. Accordingly, the overall pattern of divestment strategy includes both corporate and business focus. Twenty-three firms in the sample simultaneously pursue multiple divestment strategies, while the remaining nine follow a single type of strategy.

In Table 5, we present the types of divestment strategies followed by the firms in our sample classified according to the pre-buyout diversification strategy. The table indicates that unrelated business firms pursue a broader menu of divestment strategies compared with the related business firms, as might be expected, since they compete in a broader range of businesses in the first place. Some firms divest entire lines of business, e.g., Borg-Warner completely exited its industrial products, financial services and chemical products business, and focused on its automobile components and protective services businesses. However, other firms do not concentrate on shedding complete businesses exclusively. Rather, these firms divest assets which are related as well as those which are unrelated to the core businesses which are retained. As an example, consider Bell & Howell, which divested its Merrill publishing unit, related to the core business, as well as the unrelated career education business.

Of the related–diversified and the single business firms in the sample, two firms made no divestments at all in the post-buyout period, and in fact, there is no evidence that these firms made any significant changes in their strategic direction. Both firms were targets of hostile bids

Table 5. Divestment strategy by pre-buyout diversification type

Pre-buyout diversification type	Divestment strategy: No divestments	Market focus	Business focus	Corporate focus	Bustup
Single business	1	1	1	NA	0
Related diversity	1	3	8	NA	2
Unrelated diversity	0	3	7	7	1
Conglomerate	0	2	5	7	2
Total	2	9	21	14	5

NA = not applicable.
Cell entries refer to the number of firms in the categories.

immediately preceding the MBO, which suggests that the buyout form represented a move to retain control rather than one to alter the strategic direction of the firm. The other related–diversified industrial firms exited certain businesses, related to their core businesses, in a business focus divestment strategy. All of these firms narrowed their operations, but the magnitude of the refocusing task was considerably less than that of the more diversified firms. For example, Levi Strauss sold its hats and Koret leisurewear business but retained a substantial presence in the branded leisure apparel business.

Of particular interest are the retailers in the sample. Some of these entered the MBO with a related–diversification strategy (such as Safeway, which was a food retailer primarily with some discount wine retailing operations). Others pursued an unrelated diversification strategy (such as Revco with large drug-store operations as well as its Odd Lot discount stores). Five of the nine retailers in the sample pursued a market focus strategy. Safeway, for instance, exited the U.K. market and withdrew from certain regional markets within the U.S. to considerably narrow its geographic coverage. This strategy on the part of food retailers is influenced by the existence of significant regional economies of scale rather than economies at the national level. Furthermore, the more diversified retailers exited from entire lines of retail operations: Revco from discount store operations, Eckerd from clothing/department stores/videos, and Southland from autoparts retailing. All these divestitures share the common feature of no appreciable economies of scope across the different retail operations.

In summary, the pattern of results indicates that strategic refocusing is an important aspect of post-buyout restructuring activity. This is fully consistent with the efficiency rationale for MBOs.

Acquisition strategies in the post-buyout period

Fourteen of the 32 firms in the sample reported acquisition or facilities expansion activity in the post-buyout period. Only three of the expansion moves were large relative to the size of the MBO firm. The other transactions were relatively small; however, there is a clear strategic pattern to all the transactions, large or small. For example, four retailers took steps to achieve the benefits of regional economies of scale. Another retailer, Macy's, acquired two divisions from Federated in a move to expand its primary department store business. Macy's also opened around 100 specialty clothing stores in the post-buyout period. Three firms in the communications/broadcasting industry made acquisitions of facilities within their primary regions of operation.

Of the remaining firms, five made acquisitions or opened new plants in moves which represented growth prospects related to the core business of the firm. For instance, ARA Services has made seven acquisitions in the post-buyout time period, all of which are related to the firm's preexisting core service businesses (food, laundry, family and health care, and transportation services). Three firms in our sample (including two which also made related acquisitions) acquired unrelated businesses in the post-buyout period. All three of these acquisitions were subsequently reversed during the same post-buyout period. The evidence regarding acquisition and facilities expansion suggests that MBO firms typically pursue limited growth opportunities in their core businesses in the post-buyout period.

THE LONGEVITY AND OUTCOME OF MBOS

The central debate about the consequences of restructuring has important implications with respect to the longevity and the eventual outcome of the buyout. Clearly, if the expected costs of reduced flexibility, high debt and illiquidity significantly outweigh the possible benefits of restructuring, the buyout firm's competitive position should decline, eventually resulting in further restructuring and/or bankruptcy. However, even when the firm's decision to undertake an MBO is based on a reasonable expectation that the benefits of restructuring outweigh the costs, the outcome may be one of failure. We use the term 'failure' to refer to outcomes associated with further financial restructuring and/or bankruptcy. Factors which contribute to unsuccessful MBO outcomes are discussed in a subsequent section.

Restructuring may achieve efficiency increases in a number of different ways. If the buyout organization is more efficient than the public corporation for operating certain types of organizations (such as those in low-growth industries, as suggested by Jensen (1989)), then the buyout firm should remain private for a significant period of time. If, however, the buyout acts as 'shock therapy' (Kaplan, 1991) to accomplish major shifts in strategy which are largely one-time events, the buyout firm should return to public ownership or be sold to another firm as soon as these are achieved. The most extreme form of 'shock therapy' involves the complete dismantling of the assets and the eventual liquidation of the buyout firm, rather than return to public ownership.

Note that, even under the 'shock therapy' scenario, return to public ownership via an initial public offering (IPO) does not necessarily imply that an MBO achieved 'success.' MBO firms may return to public ownership by replacing debt with equity to ward off bankruptcy. We term this a 'financial IPO,' contrasted with a 'performance IPO' where a firm successfully restructures and then returns to public ownership. Previous studies of post-buyout performance have not made this distinction. However, as our analysis below shows, it is a material distinction.

Each of the possible outcomes (continued private ownership, return to public ownership, or bustup) is consistent with improved economic efficiency, unless 'fire sale' asset dispositions predominate. Consistent with the arguments developed above regarding the magnitude of the restructuring task confronting firms with different pre-buyout diversification strategies, we suggest that greater pre-buyout diversification is likely to be associated with longer time periods under the MBO organizational form. Our fourth hypothesis is therefore as follows:

> *H4: The time period under private ownership is longer for unrelated–diversified and conglomerate firms than for single business and related–diversified firms.*

Results

In Table 6, the pre–buyout diversification type and the final outcome of the firms in the sample are reported. The table indicates that 22 firms are still private, 4 returned to public ownership through a 'performance' IPO (having successfully restructured), 1 returned to public ownership in a financial restructuring, and 5 firms were bustups. Of the 22 firms which were still private as of December 1991, 2 were attempting to offer

Table 6. Final outcome of buyout by pre-buyout diversification type

Pre-buyout diversification type	Final outcome of buyout		
	Still private	IPO	Sold in a bustup
Single business	2	0	0
Related diversity	7	3	2
Unrelated diversity	7	1	1
Conglomerate	6	1	2
Total	22	5	5

Cell entries refer to the number of firms in the categories.

public equity in financial IPO transactions and 2 in performance IPOs, as of April 1992. In addition, the top management of another 5 of these 22 firms have made public statements which indicate that the firms are likely to stay in private ownership indefinitely. We call these the 'permanent private' firms. They include such family-managed firms as Levi Strauss and Cox Communications as well as professionally managed firms such as ARA Services.

We conducted a sum-of-ranks test to ascertain whether the number of months under the MBO organizational form differed significantly between the conglomerate and unrelated–diversified firms together (mean = 55.8 months) compared with the single and the related–diversified firms as a group (mean = 51.4 months). The null hypothesis of no difference between the two groups is rejected at the 0.05 level (one-tailed test). The test was repeated after excluding the 'permanent private' firms, three of which had pre-buyout related–diversified strategies and two of which were unrelated–diversified firms. The null hypothesis of no difference between the two groups was rejected at the 0.01 level of significance (one-tailed test). The results are therefore consistent with the proposition that greater pre-buyout diversity is associated with greater longevity of private ownership.

It is interesting to compare our results with those of Kaplan (1992) in his recent study of the longevity of 183 large LBOs completed between 1979 and 1986. As of August 1990, 62 percent of his sample buyouts are privately owned, 14 percent are publicly owned, and 24 percent have been purchased by publicly owned U.S. or foreign companies. Kaplan concludes from his evidence that 'the typical buyout is neither short-lived nor permanent' (p. 290). He furthermore suggests that the large proportion of firms which are still privately owned are consistent with the Jensen model of the buyout organizational form as a superior alternative to the public corporation in resolving the free cash flow problem in low growth industries.

In our sample, 69 percent are still privately owned, 15 percent are publicly owned and the balance 16 percent were sold in a number of transactions to public or private buyers, i.e., busted up. While our summary percentages are similar to those of Kaplan, we offer a somewhat different explanation of the results. Our in-depth analysis allows us to examine in detail the underlying causes of the longevity of the buyout firm. We first suggest that in understanding the longevity question, the 'typical' buyout may not be a particularly useful concept. There appear to be three distinct factors which underlie longevity in our sample. Of the 16 firms which remained private for over the median of 45 months, 6 were having difficulty meeting their debt obligations, 5 appeared to be 'permanent private' firms, and 5 were unrelated–diversified or conglomerate firms with, as we have suggested above, a greater magnitude of restructuring to contend with.

This analysis calls into question Kaplan's conclusion that greater longevity supports the Jensen model which proposes that the MBO organizational form is comparatively more efficient for firms in low growth industries. Rather, greater longevity appears to be associated with a number of complex factors, including the type of restructuring task (operational vs. strategic), the magnitude of the restructuring task, family ownership/motivation to control, and financial distress.

In addition, Kaplan's central research question differs from ours. He focuses on the duration of private ownership, regardless of the identity of the owner. In contrast, our interest is in the life of the buyout unit that makes the strategic decisions described above. This difference in research questions affects both the conclusions and methodology adopted.[6] Our focus is similar to BSV, although they do not calculate a longevity measure.

There is a necessary caveat to our discussion of the longevity of MBOs. It takes time for the effects of the strategic decisions in the post-buyout firm to materialize into a clearcut strategy which is associated with 'success' or 'failure.' The still-private buyout firms in our sample have had different windows of opportunity to implement their strategies, ranging from 33 months to 102 months. The pattern of strategic decisions for the younger MBOs is still unfolding, whereas the strategies of the older MBOs are

[6] For example, our measure of buyout longevity treats assets sold to divisional managers as leaving the firm and the analysis, while Kaplan's measure of longevity continues to treat these businesses as part of the buyout entity after a divisional buyout.

relatively more clearcut. In addition, there can be significant time periods which lapse between the major strategic moves made by the post-buyout firm.

Consider the case of Beatrice, which disposed of all businesses other than the domestic food businesses within 15 months of the completion of the buyout. Though the company was actively searching for buyers for the food businesses, it took approximately three more years to complete the asset sales. The market for these assets *ex-post* appeared to be thin, and the final sale to Conagra was reported to have taken place at a lower value than expected by the buyout specialists involved (Kohlberg Kravis Roberts & Co., 1989). An explanation could be that the remaining food businesses shared significant economies of scope and the resulting inseparabilities may have acted to drive up the costs of these assets relative to their benefits, from the point of view of a potential bidder. Given that such complex factors affect the realization of strategy, to address the longevity issue in more detail requires longer time-periods of observation, a typical problem of longitudinal research.

The record of repayment of debt

Some commentators determine buyout success or failure by looking at the status of debt. Measuring success is a more complex problem than simply examining the payment record of debt issued to finance the buyout. Default is at best a noisy indicator of success because it depends critically on economic conditions as well as the aggressive capital structure and activities undertaken by the post-buyout management. Nevertheless, the debt service record of a buyout contains some useful information. In this section, we examine the repayment records of our sample.

Of the full sample of 32 firms, 5 renegotiated the terms of their debt or exchanged debt to obtain more flexibility in making payments one or more times,[7] and 4 filed for protection under Chapter 11 of the bankruptcy code by December 31, 1991. Thus 9 firms (28%) were having difficulties servicing their debt.[8] The majority of the sample, i.e., 23 firms had no apparent difficulties servicing debt over the time period we consider. The positive repayment experiences of the majority of the sample firms may seem surprising in the light of news reports of catastrophic consequences of financial distress (e.g., Revco and Macy's). However, the experiences of the firms in our sample are in line with those reported by Asquith, Mullins, and Wolff (1989). They report that one-third of all junk bond issues between 1977 and 1982 resulted in default or exchange by December 31, 1988.

Two approaches were utilized to evaluate the causes of debt difficulties. First, one may hypothesize that debt problems occur less frequently for the more diversified, post-buyout firms and more frequently for the less diversified firms. Table 7 presents a cross-tabulation of payment record by post-buyout diversification type.[9] The table indicates that the incidence of financial distress is independent of post-buyout diversification type.

This result is not surprising because the table is constructed utilizing a concept of diversification based on the relatedness of the costs of production and channels of distribution for two or more products or services the firm provides, rather than the correlation of cash flows between pairs of divisions (or financial diversification). A firm with several lines of business that are all extremely sensitive to economic conditions will not be less risky than a firm with one line of business that is less sensitive to economic conditions. Risk of default should be viewed as determined by the variability of the firm's cash flows and its capital structure. The number of lines of business is at most a second order factor in assessing earnings variability.

A second approach to assessing the causes of default is to look for common factors among the

[7] One of these five firms, Macy's, filed for bankruptcy on January 27, 1992. A second firm, Charter Medical, made a prepackaged Chapter 11 filing on June 2, 1992. It emerged from bankruptcy and returned to public ownership over the next 2 months.

[8] Note that in tracking the debt service records of our sample we only followed the entity that undertook the buyout but not divisions that were sold or firms that returned to public ownership. This procedure was followed to maintain consistency with the remainder of our analysis. Bankruptcy eventually occurred for one firm that returned to public ownership following its buyout and at least one prominent divisional buyout.

[9] The bustup category was omitted from Table 7 because the hypothesis investigated here requires that an identifiable entity exists at the end of the buyout. No such entity exists after a voluntary liquidation.

Table 7. Status of firms in managing and fulfilling debt obligations by post-buyout diversification type

	Status of debt obligations at ending date	
Post-buyout diversification type	No payment difficulties	Payment difficulties
Single business	5	2
Related diversity	9	4
Unrelated diversity	2	2
Conglomerate	2	1
Total	18	9

Cell entries refer to the number of firms in the categories.

troubled firms.[10] The most common source of difficulty appears to have been regional or national economic downturn. Four firms in the sample had problems with debt service that were related to regional or national recession. The judgement that general economic conditions played an important role in the debt service difficulties of these firms was based on three factors: press reports about the firms' problems, the observation that the firm's lines of business were sensitive to economic conditions,[11] and the clustering of these problems in 1990 and 1991. General economic conditions affect the profitability of firms throughout the economy; however, the high debt levels undertaken in the immediate post-buyout period greatly magnify the effects of economic contraction or strategic error. In other words, high debt levels leave little room for bad luck or mistakes.

Other factors that appeared to have affected debt payment experiences were over-expansion by three of the nine firms, asbestos related claims for two firms and industry over-capacity for two firms. Over-expansion in the postbuyout phase could be interpreted as strategic error. Industry over-capacity may indicate that the firm was a poor target for a leveraged buyout.

Finally, the case of two firms which appeared to have failed to make investments in divisions to maintain their market position, profitability, and value is of particular interest. Early in the postbuyout period, both firms reported cash flow problems arising from negative economic and industry conditions. Given these initial problems, the firms were later reported to be unable to make necessary reinvestments in their operating businesses. For example, while its competitors were reported to spend 2 percent of revenues in refurbishing and opening new stores, Supermarkets General could only spend half that, with negative results.

This illustrates how, in a buyout, the onset of financial distress (for some reason beyond the control of managers) can be compounded by the underinvestment problem to adversely affect firm value. The firms at issue may have elected to use scarce cash flow to continue to meet debt service requirements and stave off formal default rather than making an economically profitable investment. Finance theory has shown that this behavior is in some cases the rational response for managers whose only prospect for keeping control of the firm is to delay formal bankruptcy and reorganization.[12]

THE ACQUIRERS OF DIVESTED ASSETS

Bhagat *et al.* (1990) state that transfers of ownership of divested assets consequent to

[10] The attribution of cause for debt service difficulties involves some element of reasoned conjecture. Our discussion of cause should be interpreted in that light.

[11] For example, the sales and profitability of retailers and firms that make products for construction.

[12] For additional discussion, see Myers (1977).

debt-financed restructuring might be motivated by economies of scale or scope in production and/or distribution, or by the desire to increase market power by reducing competition. They further contend that industry consolidation resulting from these transfers increases the concentration of economic power. The market power explanation could in turn imply that lax enforcement of antitrust laws influenced the buyout/takeover wave of the 1980s. This view, suggested by BSV and echoed by Jarrell in his comments on BSV, is challenged by Summers, another commentator.

BSV offer as support for their view a classification scheme for acquirers of divested assets into related, unrelated, divisional buyouts, and unknown/not applicable categories.[13] For their sample, 70 percent of divested assets were acquired by related firms. By comparison, only 16 percent of the divested assets were purchased through divisional buyouts, 8 percent were unrelated acquisitions, and 6 percent were in the other category.

BSV's classification scheme does not permit a judgement about the source of gain (cost efficiencies vs. market power) in the strategic acquisitions. To address this problem, we employed a different classification scheme. Each acquirer of a divested asset was assigned one of the following types:

Horizontal—if the selling and acquiring firms competed against each other in a local market for retailers or in a national or international market for firms not involved in retailing;

Vertical—if the acquirer purchased a division involved in either an earlier or later stage of the production process;

Market extension—if the acquirer purchased a division that sold in a market that the acquirer had not previously participated;

Product extension—if the acquirer purchased a division that made a product that was related to the acquirer's existing product mix, but in which the acquirer had not been previously involved;

Unrelated—if no similarities could be found between the divested asset and the existing activities of the acquirer;

Divisional buyout—if division managers, possibly with the aid of a buyout specialist, purchased the divested asset or the asset was spun-off to public ownership under the existing divisional managers; and

Unknown—if the identity or business of the acquirer could not be determined.

The first four categories represent different types of related acquisitions. The remaining three categories correspond to BSV's scheme.

Table 8 presents this classification scheme. The cell values in the second, third and fourth columns represent numbers of divested divisions. We chose to present this data on a per division, rather than a dollar basis for two reasons. First, a sales price was not disclosed for 45 of the 144 transactions. Second, the assumption of debt by the purchaser was not reported consistently. The last column of Table 8 presents each row total as a percent of the 144 divested assets. Not surprisingly, the table indicates that a far greater portion of the divestments are made by firms that are conglomerates or owners of unrelated assets in the pre-buyout period (107 of 144) than by firms who are more focused in the pre-buyout period (37 of 144).

The first four categories in Table 8 indicate that 86 of the 144 divested divisions (60%) represent related acquisitions for the purchaser. A comparison of these four categories allows for an assessment of the relative importance of efficiency and market power as explanations for the 86 related acquisitions. The first category, horizontal acquisitions, could be motivated by either efficiency or market power considerations. However, the other three categories (vertical, market extension, and product extension acquisitions) can only be attributed to perceived economies of scale or scope in production, distribution or management. The data indicate that 60 percent of the related acquisitions (52 of 86) were by purchasers that could only have been motivated by perceived efficiencies.

[13] While BSV report these separately, we have added the unknown and not applicable categories together. Their percentages are based on the dollar values of divested assets. BSV treat missing prices as zero; this biases their estimates downward.

Table 8. Acquirer type for divested assets by pre-buyout diversification type

Acquirer type for divested assets	Pre-buyout diversification type: Firms with single line of business or related diversity	Firms with unrelated lines of business or conglomerates	Total	% of col. total
Horizontal	12	22	34	23.6
Vertical	0	5	5	3.5
Market extension	9	18	27	18.7
Product extension	4	16	20	13.9
Unrelated	0	4	4	2.8
Divisional buyouts	8	26	34	23.6
Unknown	4	16	20	13.9
Total	37	107	144	100.0

Cell entries, except for the last column, refer to the number of divested divisions by the 32-firm sample in the categories. The last column lists each row total as a percent of the column.

In contrast, a maximum of 40 percent of the related acquisitions (34 of 86) could have been motivated by market power considerations. Of these 34 horizontal acquisitions (which constitute 24 percent of the total of 144 acquisitions) economies in distribution are the likely underlying motivation for several of the retailers. In other words, some of the asset sales represented market or business focus for the seller and a consolidation of regional economies of scale for the purchaser. In the other horizontal acquisitions, we cannot discriminate between the market power and the economic efficiency hypotheses.

BSV, further, conjecture that buyout specialists and raiders are not very important in the long run as operators of assets. Instead, BSV hypothesize that such 'incentive-intensive' organizations function primarily as dealers in divested assets. Their support for this statement is the extent of asset sales and the relative unimportance of divisional buyouts as owners of divested assets. Table 8 also provides some evidence on the permanence of ownership of the buyout targets' assets by incentive-intensive organizations. For our sample, the purchase of 34 of 144 divested assets (24%) were classified as divisional buyouts.[14] This figure is much larger than the comparable figure reported by BSV. The greater importance of divisional buyouts as well as the extended ownership by the buyout group of important portions of the pre-buyout target indicate that these organizations do play an important role in operating some, though not all, pre-buyout assets.

CONCLUSION

Given the increasing frequency and transaction size of management buyouts in the last decade, their consequences have represented an important area of interest for researchers in the strategy, industrial organization economics, and finance areas. The management buyout has the potential to represent an important vehicle for achieving strategic restructuring and improving the competitive position of the firm. However, there are clearly significant costs associated with the MBO organizational form. In this context, empirical evidence regarding restructuring activities becomes all the more crucial, to shed light on this controversial issue.

Most previous studies regarding the activities of post-buyout firms have focused on operational efficiency issues. The methodology used by many previous authors focuses on summary accounting measures as a means to evaluate the performance of buyouts. While these studies

[14] This category includes two spin-offs to public ownership in which the subsidiary managers became the top level managers of the new public firm and 32 divisional buyouts in which the equity remained privately owned.

significantly advance our understanding of the outcomes of MBOs, some important questions remain unanswered. One set of such issues pertain to an understanding of the specific strategic decisions which are implemented by buyout firms, the antecedents of these decisions and their consequences. Since the production function of the firm is likely to change in the post-buyout period, given the magnitude of the restructuring, the interpretation of summary measures in the context of the underlying issues is open to question. No previous study has provided systematic evidence regarding the strategic changes achieved by MBO firms. A likely cause is that there are severe data availability problems for understanding this question, which can only be overcome by an approach such as ours.

This paper evaluates the strategic rationale for the type of restructuring activity undertaken by MBO firms in the post-buyout period, using a combination of analytical and descriptive techniques. We thereby attempt to shed light on the complexities of the restructuring decisions. Our analysis of 32 MBOs whose pre-buyout values exceeded $500 million suggests that, first, buyouts are not exclusively vehicles for bustups. Rather, they appear to be vehicles for focusing the strategic activities of the firm towards the more related businesses. We make this finding despite the fact that our sample is biased towards large firms which are likely to be more diversified and therefore most likely to be bustups. To the extent that pursuit of unrelated lines of business detract from the firm's competitive advantage in the core business, this strategic redirection contributes to firm-level performance and social efficiency.

Second, we document the outcomes and longevity of MBO transactions. Our evidence indicates that buyouts often continue to operate significant portions of the original assets. The overwhelming majority of the firms in our sample operate as private firms for lengthy periods of time, though frequently at a reduced scale and scope. It is also clear that the very high levels of leverage in the post-buyout firm leave little room for strategic error and increase its vulnerability to economic downturns. In examining the debt repayment record of our sample firms, the time period we consider includes the 1989–91 years of sluggish growth and recessionary conditions in the U.S. economy. Some firms in our sample do face difficulties in meeting their debt obligations. However, the proportion of troubled firms represents only 28 percent of our sample. This proportion is in line with the rate of junk bond defaults reported by Asquith *et al.* (1989) for an earlier period.

Finally, the evidence regarding the changed ownership of the buyout firms' divested assets calls into question previous assertions regarding the motivations of buyers. It does not appear, from the evidence here, that these transactions resulted from lax enforcement of antitrust laws during the 1980s. We suggest that strategic efficiency considerations, rather than market power, are the predominant explanation for ownership changes.

APPENDIX

This appendix provides information about the strategic restructuring activities of the sample firms. For each firm, the year of completion of the buyout is identified, and the name of the affiliated buyout specialist, if any. Each case briefly lists the businesses which the firm was engaged in prior to the buyout and the changes which occurred in the post-buyout phase. The final ownership status of the firm is provided.

AFG Industries, Inc.

1988 buyout by team headed by AFG Chairman Randall Hubbard. The company was an integrated manufacturer and fabricator of flat glass products, emphasizing value-added, specialty products. In the year prior to the buyout, the company entered the automobile replacement glass business, which was divested in the post-buyout period. Private as of December 1991.

ARA Services, Inc.

1984 buyout by team of 70 senior managers led by ARA Chairman Joseph Neubauer. The company provided or managed services in food and refreshment, health and family care, transportation, textile rental and maintenance, and magazine book distribution. Divested transportation unit just prior to buyout. Post-buyout, sold airline services subsidiary, marginally profitable small vending operations, and Smith Transfer trucking unit. Made several horizontal/product extension acquisitions. Private as of December 1991.

American Standard Inc.

1988 buyout led by Kelso & Co. The company was a diversified manufacturer of air-conditioning products, transportation products including automobile braking and railroad equipment, and building/plumbing products. In the post-buyout period, the company sold its headquarters property, Steelcraft Division (steel doors and architectural products), railroad equipment divisions, and one of its refrigeration units. Private as of December 1991.

Beatrice Companies, Inc.

1986 buyout led by Kohlberg Kravis Roberts & Co. The company's businesses included processing and distributing food products, consumer products, and car rental. Within 2 years of the completion of the buyout, the firm had sold its car rental, soft drink bottling, personal products, cosmetics, dairy products, refrigerated warehousing, printing, lamps, luggage and bottled water businesses. The international food units were sold shortly thereafter, as were the Tropicana Juice and Fisher Nuts businesses. The sale of the remaining branded food products businesses was accomplished by mid-1990.

Bell & Howell Co.

1988 buyout led by investor Robert Bass. The company was involved in career education (electronics and computer science schools), publishing (textbooks and micropublishing), visual communications systems, information storage and retrieval and document/mailing processing. In the post-buyout period, the company exited the career education business, divested its holdings in Bell & Howell/Columbia Paramount Video Services, and sold various noncore businesses. Sold the core publishing unit (Merrill Publishing) in 1989. Private as of December 1991.

Borg-Warner Corporation

1987 buyout led by Merrill Lynch. This conglomerate operated in four business segments: chemicals & plastics, financial services, protective services and transportation equipment. Post-buyout, the company sold its chemicals & plastics and financial services units to focus on the automotive parts and protective businesses. Private as of December 1991.

Burlington Industries, Inc.

1987 buyout led by Morgan Stanley. The company was a vertically-integrated manufacturer of yarn, textiles, carpets and related products for apparel, home and industry. In the post-buyout period the company sold 10 of its businesses including automobile interior products, glass fabrics and industrial fabrics, to focus on apparel and interior furnishings. Also sold 8 manufacturing and other facilities including its largest denim factory, one of its core activities. Private as of December 1991.

Charter Medical Corporation

1988 buyout led by Chairman, President and founder, William A. Fickling. The company primarily owned and operated psychiatric hospitals. Also owned acute care general hospitals and provided various medically-oriented services. Post-buyout, sold or closed a number of psychiatric hospitals and one acute care general hospital. In the same time period, substantially expanded in the psychiatric hospital sector. Private as of December 1991.

Cox Communications, Inc.

1985 buyout by the Cox family, which previously owned 40 percent of the company. The company owned and operated television and radio stations and cable television systems; produced motion pictures; operated automobile auctions; and owned and operated data service and paging services businesses. Post-buyout, the company divested certain of its television, radio, and cable system properties while acquiring other properties in the same lines of business. Divested its data services and paging services businesses. Substantially expanded its automobile auction business. Private as of December 1991.

Denny's, Inc.

1985 buyout led by Merrill Lynch. The company was engaged in the foodservice business mainly through Denny's restaurants, Winchell's Donut Houses, and El Pollo Loco restaurants. In the post-buyout period, the company spun off a 58 percent interest in Winchell's to public shareholders. The company expanded its chain of Denny's and El Pollo Loco restaurants. In July 1987, the company was sold to TW Services.

Jack Eckerd Corporation

1986 buyout led by Merrill Lynch. The company focused its retailing activities considerably in the 6 months prior to the buyout, divesting its J. Byrons department stores, casual wear clothing stores, & American Home Video specialty stores. At the time of the buyout it owned and operated drug stores in Sunbelt markets and optical stores in five states. Post-buyout strategy of related diversification into photo stores, expansion of its core drug store business, and downsizing its optical store operations. Private as of December 1991.

Fort Howard Corporation

1988 buyout led by Morgan Stanley. The Company manufactured disposable paper products, including napkins, towels, toilet tissue, and boxed facial tissue; food and beverage service products of plastic, paper and foam including tableware and containers, and packaging and labeling products. Post-buyout, sold its paper cup operations, launched a line of bathroom tissues and paper towels of fully-recycled fibers, and planned to expand capacity at its Green Bay plant by 20 percent. Private as of December 1991.

GAF Corporation

1989 buyout led by Chairman, Samuel J. Heyman. The company was engaged in the manufacture and sale of specialty chemicals and building materials. Shortly after the buyout, added a subsidiary to its Chemicals Division. Within a year of the buyout, the company sold its surfactant unit to Rhone–Poulenc. Took its International Specialty Products subsidiary, which contained the remaining specialty chemical businesses, public in June 1991. GAF Corporation, with full ownership of the building products businesses, continued to be privately held as of December 1991.

Hospital Corporation of America

1989 buyout led by Chairman T. F. Frist, Jr. In the year prior to the buyout, the company sold 104 hospitals to a new employee-owned company, called Health Trust Inc., in which it retained a sizeable stake. The remaining larger hospitals (including psychiatric and acute care facilities in the U.S. and overseas) provided more sophisticated medical services. Also had management contracts and consulting agreements with other health care facilities. Post-buyout, sold its hospital management subsidiary and clinical laboratory unit to units' senior managers, and divested Australian operations as well as the bulk of its Health Trust Inc. stake. Private as of December 1991.

Lear Siegler Inc.

1987 buyout led by Forstmann Little. This conglomerate produced aircraft and aerospace systems, automotive products, material handling systems, boats, handguns, telecommunications equipment and furniture components. In the post-buyout period, sold most of its businesses to focus primarily on automotive glass products, with some other smaller operations. Private as of December 1991.

R. H. Macy & Co., Inc.

1986 buyout led by Chairman & CEO Edward S. Finkelstein. The company owned and operated medium-to-high price department stores in 14 states, and shopping centers in 4 states. Shortly prior to the buyout, the company sold Missouri & Kansas stores. Post-buyout, the company divested its shopping center businesses and credit card business. Purchased the I. Magnin and Bullocks Wilshire divisions of Federated Department Stores Inc. and entered the specialty stores field. Private as of December 1991.

Metromedia, Inc.

1984 buyout led by Chairman John Kluge. The company consisted of four operating groups of companies: (1) Television and Radio Broadcasting, (2) Outdoor Advertising, (3) Entertainment (production and distribution of television programs, video tape production services, touring teams providing basketball entertaining, touring ice shows, indoor ice skating rinks), and (4) TeleCommunications (cellular phone and radio paging). Post-buyout, sold all of the above businesses. Acquired a substantial stake in Orion Pictures, and entered the long-distance telephone services industry. Reorganized under the name Metromedia Co., which is private as of December 1991.

National Gypsum Company

1986 buyout led by Goldman Sachs. The company was an integrated, diversified manufacturer of products for the building construction industry and provided design, engineering and construction services for industrial and commercial markets. Post-buyout, the company sold its decorative products division, cement distribution facilities, ceramic floor/wall tiles division, glass products division, and windows/doors division. It focused on its gypsum wallboard business and design/engineering services. Private as of December 1991.

Owens-Illinois, Inc.

1987 buyout by Kohlberg Kravis Roberts & Co. The company was a diversified manufacturer of glass containers, specialized glass products, plastic containers and multipack carriers, metal and plastic closures, pharmaceutical packing, paperboard & containers, and plywood and dimension lumber. It also owned nursing/retirement homes. Postbuyout, the company sold its forest products division and spun off its nursing homes to public shareholders. Acquired Brockway Inc, a glass and plastic container manufacturer, to become the leading glass container maker in the U.S. Set up a joint venture for manufacture of television screens. Returned to public ownership in December 1991.

Parsons Corporation

1984 buyout by company's employee stock ownership plan, spearheaded by Chairman & CEO William E. Leonhard. The company provided design, engineering, procurement, and construction services in industry worldwide. No apparent changes in strategy in the postbuyout period. Private as of December 1991.

Payless Cashways Inc.

1988 buyout led by David Stanley, Chairman & CEO. The company and its subsidiaries operated a chain of retail stores in 26 states located primarily in the Midwest, Southwest, Pacific Coast and New England areas which sold extensive lines of building and home improvement products. Post-buyout, closed two stores and opened two new stores. Private as of December 1991.

Revco Drug Stores, Inc.

1986 buyout led by Transcontinental Services. The company owned and operated retail drug stores and close-out merchandise stores. It also owned a liquid generic drug manufacturer and a vitamin manufacturer, a computer software company, an insurance agency, and various other businesses. Post-buyout, the company sold its Odd-Lot off-price retail operations and some of its nondrugstore businesses. Tried unsuccessfully to pursue a strategy of upgrading its drug stores to department stores. Subsequently downsized its drug store operations considerably. Private as of December 1991.

Safeway Stores, Inc.

1986 buyout led by Kohlberg Kravis Roberts & Co. The company owned and operated conventional supermarkets. 'Food Barn' warehouse-type food stores, super-warehouse stores, and 'Liquor Barn' discount liquor stores; also owned and operated distribution, manufacturing and processing operations in support of its retail operations. Post-buyout, sold its U.K. and Australian operations, discount liquor and warehouse food stores, and exited a number of regional grocery markets to focus primarily on the northwestern U.S., Rocky

Mountain, and Canadian markets. Returned to public ownership in April 1990.

SCOA Industries, Inc.

1985 buyout led by Thomas H. Lee, a Boston buyout specialist, and Drexel Burnham Lambert Inc. Company was engaged in general merchandise discount retailing (primarily Hills Department Stores) in the East and Midwest and footwear operations throughout the U.S. Sold footwear retailing operations to focus on discount department stores. The company returned to public ownership in 1987.

Southland Corporation

1987 buyout by the Thompson family including John P. Thompson & Jere W. Thompson, Southland's two top executives. The company operated and franchised convenience stores doing business principally under the name 7-Eleven, and owned 50 percent of Citgo Petroleum. Other businesses included processed dairy products; fast food products primarily for intracompany sale, and autoparts retailing. Post-buyout, sold its dairy product groups, auto parts retail business, some fast-food manufacturing operations and holdings in Citgo. Also downsized convenience store operations. In March 1991, after bankruptcy reorganization, control of the company was transferred to Ito-Yokada Group, operator of Southland's stores in Japan and public trading of new equity was resumed.

The Stop & Shop Companies, Inc.

1988 buyout led by Kohlberg Kravis Roberts & Co. The company owned and operated Bradlees discount department stores and Stop & Shop supermarkets in Northeast and Mid-Atlantic states; also owned and operated manufacturing and distribution operations in support of its retailing businesses. Sold a number of Mid-Atlantic Bradlees stores to focus on Northeast markets. Returned to public ownership in 1991.

Storer Communications, Inc.

1985 buyout led by Kohlberg Kravis Roberts. The company owned and operated seven television stations, and cable systems in 18 states. Post-buyout, divested some cable properties. Sold its broadcast properties in 1987, the majority to a joint venture of KKR and George Gillett ('SCI Television Inc.'). In 1988, sold the remaining cable assets ('SCI Holdings Inc.') to Comcast and Tele-Communications Inc.

Levi Strauss & Co.

1985 buyout by the Haas family. The company was the world's largest producer of branded apparel, marketing a broad range of leisure-oriented clothing throughout the world. Post-buyout, reversed earlier diversification moves by selling Koret, a woman's sportswear company, and its Resistol Hats division. Continued to expand in its basic jeanswear product line. Private as of December 1991.

Supermarkets General Corporation

1987 buyout led by Merrill Lynch. The company was a diversified retailer operating 'Pathmark' supermarkets and drug stores in northeast and mid-Atlantic states, and 'Rickel Home Center' home improvement stores. The company also owned and operated the Purity Supreme chain of supermarkets in New England. Postbuyout, the company shut down eight of the company's struggling Rickel stores, and sold its Purity Supreme chain to focus on the Pathmark chain. Private as of December 1991.

Uniroyal, Inc.

1985 buyout led by Clayton & Dubilier. The company manufactured and sold tire and related products; chemicals, rubber and plastic materials; and engineered products and services. Post-buyout, formed a 50–50 joint venture with Goodrich to combine the two companies' tire operations ('Uniroyal Goodrich Tire Co.'). Sold its chemicals unit, plastics unit and power transmission unit to focus on tire operations. Bought out the Goodrich half interest in the joint venture in 1987. Sale of the tire company to Groupe Michelin in 1990.

Jim Walter Corporation

1988 buyout led by Kohlberg Kravis Roberts & Co. The company was engaged in construction/

sales/financing of shell-type homes; manufacture and distribution of building materials including asbestos insulation products, aluminum products, window components and marble products; coal and gas mining and transportation; pipe and foundry products; production of coke and industrial chemicals; jewellery wholesaling and retailing; and paper distribution and office supply. Post-buyout, sold the paper operations, Georgia Marble subsidiary, jewellery operations, and Celotex Corp (asbestos insulation products). Hillsborough Holdings Corporation, which owns the remaining assets, was privately held as of December 1991.

Wometco Enterprises, Inc.

1984 buyout led by Kohlberg Kravis Roberts & Co. The company's businesses included television and radio broadcasting; cable television systems; entertainment (motion picture theaters, the Miami Seaquarium, guided tour services and other entertainment ventures); and soft drink bottling and vending. Within 3 years of the buyout, the different businesses were sold to various acquirers.

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