

Who does private equity buy? Evidence on the role of private equity from buyouts of divested businesses

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Research Summary: We examine the role of nonventure private equity firms in the market for divested businesses, comparing targets bought by such firms to those bought by corporate acquirers. We argue that a combination of vigilant monitoring, high-powered incentives, patient capital, and business independence makes private equity firms uniquely suited to correcting underinvestment problems in public corporations, and that they will therefore systematically target divested businesses that are outside their parents' core area, whose rivals invest more in long-term strategic assets than their parents, and whose parents have weak managerial incentives both overall and at the divisional level. Results from a sample of 1,711 divestments confirm these predictions. Our study contributes to our understanding of private equity ownership, highlighting its advantage as an alternate governance form.

Managerial Summary: Private equity firms are often portrayed as destroyers of corporate value, raiding established companies in pursuit of short-term gain. In contrast, we argue that private equity investors help to revitalize businesses by enabling investments in long-term strategic resources and capabilities that they are better able to evaluate, monitor, and support than public market investors. Consistent with these arguments, we find that when acquiring businesses divested by public corporations, private equity firms are more likely to buy units outside the parent's core area, those whose peers invest more in R&D than their parents, and those whose parents have weak managerial incentives, especially at the divisional level. Thus, private equity firms systematically target those businesses that may fail to realize their full potential under public ownership.

KEY WORDS

buyout, corporate governance, divestiture, private equity, underinvestment

1 | INTRODUCTION

Buyouts by private equity (PE) firms are an increasingly important phenomenon of the contemporary corporate landscape, one that has attracted growing interest in the strategy literature (Castellaneta & Gottschalg, 2016; Hoskisson, Shi, Yi, & Jin, 2013; Seth & Easterwood, 1993; Wiersma & Liebeskind, 1995). Early accounts of buyouts highlighted their role in disciplining managers (Jensen, 1986; Williamson, 1988) and correcting value-destroying diversification (Berger & Ofek, 1996), and warned that the short-term focus of private equity buyers might have adverse long-term consequences (Fox & Marcus, 1992; Long & Ravenscraft, 1993). In contrast to this view, private equity investors themselves identify “growth in the value of the underlying business” as the most important driver of the deals they make (Gompers, Kaplan, & Mukharlyamov, 2015), and researchers have found little evidence of a short-term orientation among PE investors (Harford & Kolasinski, 2014; Smith, 1990), with studies showing that many buyouts, especially those involving smaller targets, are held for substantial periods of time (Kaplan & Stromberg, 2009; Wright, Robbie, Thompson, & Starkey, 1994). This has led scholars to argue for an entrepreneurial role for buyouts (Berg & Gottschalg, 2005; Wright, Hoskisson, Busenitz, & Dial, 2000), with empirical evidence confirming that the positive effects of buyouts are associated with long-term improvements in productivity (Harris, Siegel, & Wright, 2005; Lichtenberg & Siegel, 1990), performance (Cumming, Siegel, & Wright, 2007; Palepu, 1990), monitoring and incentives (Guo, Hotchkiss, & Song, 2011; Holthausen & Larcker, 1996), and innovation (Holthausen & Larcker, 1996; Rubera & Tellis, 2014; Zahra, 1995). There is thus a need for a stronger theoretical account of the role of PE firms.

Existing research has also paid relatively little attention to the nature of targets that PE firms pursue, focusing more on the performance consequences of buyouts. A few early inquiries (Maupin, 1987; Singh, 1990) aside, hardly any studies have looked at the antecedents of buyouts. There is also limited work examining divisional buyouts, that is, buyouts of businesses divested from a larger firm (Hite & Vetsuydens, 1989; Meuleman, Amess, Wright, & Scholes, 2009), with most studies focusing on buyouts of stand-alone firms. Yet empirical evidence shows that divisional buyouts are the modal transaction type (Cumming et al., 2007; Kaplan & Stromberg, 2009), and that PE firms account for a substantial proportion of acquisitions of divested businesses (Berger & Ofek, 1996). Understanding which businesses PE firms target may thus help enhance our understanding of the strategies of PE firms, and the role they play relative to corporate acquirers.

Our study is an attempt to explore the attributes of businesses bought by private equity firms, and to compare target choices of PE firms versus corporate buyers. Theoretically, we contend that PE ownership is a unique governance form designed to address situations where incentive alignment with public equity markets may fail to ensure adequate investments in long-term specialized assets (Williamson, 1988, 1990). Publicly owned firms may suffer from problems of coordination costs, myopia, and low-powered incentives (Graham, Harvey, & Rajgopal, 2005; Markides, 1992; Williamson, 1985; Zhang & Gimeno, 2010), which may cause them to underinvest in potentially

valuable long-term opportunities (Benner & Zenger, 2016; Folta & Janney, 2004; Myers & Majluf, 1984). PE ownership is a governance form that helps to correct these problems, bringing to bear a combination of stronger incentives, better-informed monitoring, patient capital, and an ability to leave businesses independent. It follows that PE acquirers should systematically target businesses that are suffering from underinvestment under their current owners—including those that lie outside the parent's core area, those that require greater long-term strategic investments than the parent is likely to provide, or those that have weak long-term incentives, especially for divisional managers. Not only will PE firms be able to better govern such businesses than their parent firms, they may also have an advantage relative to other corporate acquirers, who may face the same governance problems as the erstwhile parents (Williamson, 1985).

We test our theory by focusing on buyouts of businesses divested by public corporations, a setting that not only allows us to study the relatively unexplored phenomenon of divisional buyouts, but also enables us to directly compare the choices of PE acquirers to those of corporate acquirers. Consistent with our theory, results from a sample of 1,711 divestments by publicly listed U.S. manufacturing sector firms from 1997 to 2010 show that PE firms are more likely to acquire noncore businesses, businesses whose rivals spend more on R&D than their parents, and businesses whose parents offer weak long-term incentives to their top executives, with weaker incentives for divisional executives than for corporate executives.

Our study advances our collective understanding of PE buyouts. We hope to contribute to a growing literature on this important phenomenon, by studying the types of targets that are most likely to be bought by private equity acquirers, and systematically comparing the target choices of PE firms to those of corporate acquirers in this context. In doing so, we offer a new theoretical perspective on the competitive advantage of PE firms relative to corporate acquirers in correcting problems of underinvestment in public corporations. In addition, we contribute to the study of corporate governance more generally, highlighting the drivers of underinvestment in publicly held corporations (Folta & Janney, 2004; He & Wang, 2009; Litov, Moreton, & Zenger, 2012), and the role of private equity in addressing these problems (Benner & Zenger, 2016).

2 | THEORY AND HYPOTHESES

2.1 | Underinvestment and the role of private equity

The separation of ownership from control is a central feature of the public corporation (Berle & Means, 1932; Fama & Jensen, 1983). A substantial literature has highlighted the agency problem arising out of this separation, arguing that as the interests of managers and shareholders diverge, managers may be motivated to pursue their own interests rather than those of shareholders, with the result that managers may make self-serving investments to lower their employment risk (Baysinger, Kosnik, & Turk, 1991; Markides, 1992; Rajan, Servaes, & Zingales, 2000), engage in “empire-building” (Jensen, 1993), or prioritize “the quiet life” (Bertrand & Mullainathan, 2003). Solutions to these agency problems generally involve a combination of stronger monitoring and better aligned incentives to make managers more responsive to owners (Daily, Dalton, & Cannella, 2003; Walsh & Seward, 1990).

Such mechanisms may, however, prove maladaptive if shareholders have an inferior understanding of the business compared to managers (Benner & Zenger, 2016; Feldman & Montgomery, 2015; Manso, 2011). This “separation of ownership from information” (Edmans, 2009, p. 2485) may arise because the need to keep strategic information private may make it difficult for managers to meet

the level of disclosure required by public markets (Aggarwal & Hsu, 2014; Bettis, 1983; Folta & Janney, 2004), because investors holding highly diversified and rapidly changing portfolios may have little ability or incentive to develop an in-depth understanding of the businesses in which they invest (Cremers & Pareek, 2016; Gilson & Gordon, 2013), because equity market investors may be subject to a variety of cognitive biases (Barberis & Thaler, 2003; Schijven & Hitt, 2012; Shiller, 2003), or because the lack of specialized or technological knowledge on the part of shareholders may make it challenging for them to correctly value previously unobserved investments (Delong & Deyoung, 2007), such as those involving technological or business-model innovation (Hitt, Hoskisson, Johnson, & Moesel, 1996; Folta & Janney, 2004; He & Wang, 2009). For all these reasons, equity market assessments of investment opportunities may not accurately reflect their true value (Greenwald & Stiglitz, 1990; Stiglitz, 2000). Managers exposed to substantial pressure from public equity markets may therefore be driven to cut back on long-term investments (Graham et al., 2005; Myers & Majluf, 1984), such as investments in R&D (Bushee, 1998; Zahra, 1996) and capacity expansion (Souder & Shaver, 2010; Zhang & Gimeno, 2010).

How may the problem of underinvestment in public corporations be solved? Clearly, simply granting managers greater discretion is not a solution, since this would only allow agency problems to rear their ugly head (Williamson, 1985). One solution (though certainly not the only one) is to take the business private (Folta & Janney, 2004; Hertzel & Smith, 1993), replacing atomistic public owners with more concentrated holdings by investors who have the information and expertise to govern managers more effectively¹ (Edmans, 2009). Our main contention in this study is that private equity constitutes an alternate governance arrangement specifically designed to serve this purpose (Wruck, 2008). In particular, we believe that PE firms will have an advantage in undertaking long-term strategic investments whose unique, specialized, and uncertain nature (Williamson, 1979, 1985) makes them especially challenging for public equity markets to correctly value (Benner & Zenger, 2016; Litov et al., 2012). Once the value of these investments is realized, and the uncertainty associated with them resolved, PE firms may exit the business, returning it to public ownership (typically through sale to a corporate acquirer), and capturing the value of their investments. Thus, PE ownership represents a transient governance form (Nickerson & Zenger, 2002), one that serves an entrepreneurial purpose by enabling investments in strategic resources and capabilities when required (Wright et al., 2000; Zahra, 1995).

In order to explicate the advantages of PE governance, and to derive a set of empirically testable hypotheses in line with our theory, we focus on the choice of targets pursued by PE firms when buying businesses divested by public corporations.² We focus on target selection both because, as discussed above, we believe the choice of buyout targets is an important yet understudied question in PE research (Maupin, 1987; Singh, 1990), and because focusing on the choice of public targets allows us to bypass problems of confidentiality and selective disclosure around PE firms' actions postacquisition and to study PE activity in a large, cross-industry sample. Moreover, by looking at acquisitions of divested businesses we are able to compare the target choices of PE firms with those of corporate buyers, in a context where the two types of buyers are potentially in competition. The logic for our approach draws on the principle of discriminating alignment: every transaction or

¹This is also the argument in favor of long-term institutional investors, who may be better positioned to support innovative and longer-term investments (Benner & Ranganathan, 2013; Bushee, 1998; Zahra, 1996). Unlike PE buyers, however, such investors can only invest in firms, and cannot target specific divisions or businesses within a firm.

²Firms may divest businesses for many reasons (Berry, 2010; Brauer, 2006; Feldman & McGrath, 2016), examining the full range of which is beyond our scope. For the current study, we therefore focus both theoretically and empirically on target choice conditional on divestment, that is, given that a public firm has chosen to divest an asset, what are the chances that it will be acquired by a PE firm rather than a corporate acquirer?

activity should be placed under the governance form that allows it to be carried out at the lowest total cost, including transaction costs (Williamson, 1991, 1998). It follows that if PE firms are especially well suited to the governance of businesses that may suffer underinvestment under public ownership, we should see this reflected in their choice of acquisition targets (Kaul & Wu, 2016; Mitchell & Shaver, 2003), with PE firms being systematically more likely to acquire such targets.³ Not only will PE firms have an advantage in governing these businesses relative to their corporate parents, they may also have an advantage relative to potential corporate acquirers, who may themselves be plagued by the same governance problems as the erstwhile parent, and may struggle to undertake the selective intervention necessary to realize value from correcting underinvestment problems (Williamson, 1985).⁴ The predictions we develop below are thus meant to suggest a separating equilibrium, with PE firms systematically going after targets that have suffered underinvestment under their corporate parents, while corporate acquirers rationally and successfully pursue targets that offer the potential for complementarities (Capron & Pistre, 2002; Kim & Finkelstein, 2009; Laamanen, Brauer, & Junna, 2014).

2.2 | Coordination costs

We begin by considering the problem of coordination costs in large corporations (Jones & Hill, 1988; Williamson, 1985; Zhou, 2011) and the potential for such costs to lead to suboptimal performance as firms spread themselves too thin (Markides, 1992, 1995). While placing multiple businesses within a single organization can enable coordination between them, allowing for the realization of value from the creation and use of co-specialized assets, this coordination is achieved at the cost of adaptation within each business (Williamson, 1991). In particular, increasing breadth of businesses may result in problems of misallocation and opportunism within the organization (Jones & Hill, 1988; Williamson, 1985, 1988). These problems may be especially severe in the case of noncore businesses—that is, businesses that are unrelated to the firm's primary business activities and share few, if any, resources, with them (Bergh, Johnson, & Dewitt, 2008; Kaul, 2012)—since such businesses would see limited benefits and high costs from coordination (Bergh & Lawless, 1998; Markides, 1995; Zhou, 2011). In the extreme, such businesses may be better off governed independently.

High coordination costs may cause underinvestment in noncore businesses in a number of ways. First, excessive diversification is associated with information loss (Berger & Ofek, 1996; Markides, 1992), with noncore businesses receiving limited attention from the top managers of diversified firms, and these managers having a relatively limited understanding of businesses outside the core (Bergh et al., 2008; Liebeskind, 2000). Second, noncore businesses may be especially difficult for financial markets to correctly evaluate, with analysts and investors having a hard time assessing unusual business combinations or businesses that lie outside their areas of expertise (Litov et al., 2012; Zuckerman, 1999, 2000), and the performance of noncore businesses being obfuscated when combined with company-wide results (Folta & Janney, 2004; Rajan et al., 2000). Third, as recent work applying a behavioral perspective to capital allocation decisions has pointed out, the allocation

³Such a matching may be the result of PE firms systematically recognizing and pursuing such targets *ex ante*, or it may result from a competitive bidding process between PE firms and corporate acquirers where the former's superior governance makes them more likely to emerge successful *ex post*.

⁴Unrelated acquirers may certainly try to pursue strategies similar to PE firms, mimicking their organizational characteristics. Given the infeasibility of selective intervention (Williamson, 1985), however, our claim is that such acquirers will find it more challenging to correct underinvestment problems than PE firms *on average*. We investigate the role of unrelated corporate acquirers empirically in supplementary analyses below.

of funds between businesses in large firms is often suboptimal, with funds being allocated based on performance aspirations (Arrfelt, Wiseman, & Hult, 2013; Arrfelt, Wiseman, McNamara, & Hult, 2015), or concerns for equality (Bardolet, Fox, & Lovallo, 2011), rather than on future potential, leaving high potential but marginal businesses susceptible to underinvestment (Gaba & Joseph, 2013). Fourth, noncore businesses may be at a disadvantage in navigating the politics of conflict and compromise within the organization (Argyres, 1995; Williamson, 1985), since they are likely to have limited power within the organization, and their interests are likely to be poorly aligned with those of the firm's primary business. For all these reasons, we believe that underinvestment problems will be most severe for noncore businesses.

PE firms may be able to correct the underinvestment in noncore businesses, not only because they can restore such businesses to independence—giving them the attention and focus they deserve and eliminating the costs of coordination—but because they are more likely to be able to maintain this independence over time. As alternate owners who bring few, if any, synergies to the table, PE firms are likely to offer limited interference in the target's day-to-day operations, their primary role being to monitor and incentivize the target's managers rather than to replace them. In this, they are likely to have an advantage over corporate acquirers, who would logically want to integrate the acquired business in order to realize operating synergies (Barkema & Schijven, 2008a; Kim & Finkelstein, 2009), and may therefore prove more disruptive to the acquired business (Puranam, Singh, & Chaudhuri, 2009). Moreover, even if a corporate acquirer were to try and preserve the independence of the acquired business, the business would still be placed within its existing hierarchy, and the infeasibility of selective intervention would lead to “unavoidable side effects” (Williamson, 1985, p. 138) that would lower the business's performance. Thus,

Hypothesis 1 (H1) *Divested businesses outside the parent's core business are more likely to be acquired by private equity firms than by corporate acquirers compared to those within the parent's core business.*

2.3 | Myopia in strategic investments

A second problem with public ownership is that of myopia, with managers exposed to public market pressure tending to underinvest in long-term strategic assets (Edmans, 2009; Graham et al., 2005)—such as R&D (Aghion, Van Reenen, & Zingales, 2013; Bushee, 1998; Zahra, 1996) and long-term capacity (Souder & Bromiley, 2012; Souder & Shaver, 2010; Zhang & Gimeno, 2010)—in order “to maximize immediate net receipts” (Williamson, 1985, p. 138). There are several reasons why long-term strategic investments may be especially susceptible to this problem, and why PE firms may have an advantage in undertaking such investments.

First, investments in long-term strategic assets are likely to be subject to problems of disclosure (Bettis, 1983; Williamson, 1985). Given the strategic nature of such investment opportunities, firms would rationally be loath to share all relevant information about them with the general public, for fear of destroying their value. Yet, the very secrecy necessary to preserve the value of the opportunity may also compromise the firm's ability to raise funding for such investments from the public markets (Aggarwal & Hsu, 2014; Bettis, 1983; Stiglitz, 2000). PE firms could overcome this problem by allowing for confidential disclosure to investors (Folta & Janney, 2004). While managers of corporate acquirers could also receive confidential disclosures, they would then face the challenge of justifying their acquisitions to their own investors without violating confidentiality. PE firm managers, in contrast, are not subject to the same short-term pressure to justify individual investments to

their investors, so long as they can produce long-term performance (Fenn, Liang, & Prowse, 1997); nor are they subject to the same disclosure requirements as managers of public corporations.

Second, long-term investments may face problems of recognition (Williamson, 1985). Strategies that confer long-term competitive advantage are likely to be unique (Litov et al., 2012), and investments in such opportunities are likely to involve subjective judgment in the face of uncertainty (Kaul, 2013; Knight, 1921). These very characteristics, however, make it challenging for public equity markets to accurately value such investments (Benner & Zenger, 2016), with analysts and investors having a hard time assessing innovative investments (Benner, 2007, 2010; He & Wang, 2009) or valuing strategies that depart from the categories or configurations they are familiar with (Campbell, Sirmon, & Schijven, 2016; Litov et al., 2012; Zuckerman, 1999, 2000). Once again, PE firms may have an advantage in recognizing the value of such opportunities (Benner & Zenger, 2016). As dedicated, active, and well-connected players in the market, PE firms have superior access to information and analysis (Hertzel & Smith, 1993) and may therefore be less reliant on the crude and potentially biased signals used by less sophisticated investors (Schijven & Hitt, 2012; Shiller, 2003), and less susceptible to cognitive biases (Barberis & Thaler, 2003). Given their more concentrated investments, PE firms may also have stronger incentives to invest in gathering information and developing specialized expertise (Edmans, 2009), compared to highly diversified portfolio investors (Gilson & Gordon, 2013).

Finally, the ability of publicly owned firms to invest in long-term strategic assets may be further compromised by the short-term, speculative nature of public equity investors. Because investments in long-term strategic assets often lead to early short-term losses (Manso, 2011), they may be received negatively by impatient equity market investors, placing managers' employment at risk (Edmans, 2009; Stein, 1989). Investments in such long-term assets may require patient financial capital, that is, capital that is invested with no intention of liquidation for substantial periods of time (Cremers & Pareek, 2016; Sirmon & Hitt, 2003; Teece, 1992). PE firms represent an important source of such patient capital: by the very nature of the business, investors in PE funds will tend to be more patient, longer-term investors, so that PE firms may be less concerned with short-term liquidity or quarterly earnings than corporate acquirers, especially those that are public themselves (Fenn et al., 1997; Folta & Janney, 2004). At the same time, because PE firms and their investors realize most of their returns when they exit the business, they will have a strong need to realize substantial performance improvements in acquired businesses within a 5–10 year time horizon, which may not be the case for large and highly diversified public corporations with substantial amounts of financial slack (Bercovitz & Mitchell, 2007). Thus, the investment horizon that PE firms bring to bear may be just right to support strategic investments—long enough to make immediate gains less salient and allow for uncertainty and tolerance of initial failure, but short enough to enforce accountability.

It follows that PE firms are likely to systematically target businesses suffering from underinvestment in long-term strategic assets such as new technologies and durable capital assets under their corporate parent. In particular, we think that lines of business where the level of investments in long-term strategic assets by the business's rivals is greater than the level of investments in such assets by the corporate parent may be especially ripe for a PE buyout. We focus on the level of long-term investments at the parent rather than the business level for two reasons.⁵ First, while firms

⁵Pragmatically, measuring strategic investments at the business level in diversified firms is challenging, given that such investments are not consistently reported at the business level in public data, and are susceptible to manipulation in how costs are allocated across businesses—in fact, it is this very difficulty that leads to underinvestment in long-term strategic assets at the business level in the first place.

could, and do, allocate investments differently across their internal businesses, substantial differences in relative allocation may lead to invidious comparisons among units (Williamson, 1985), leading to internal conflict and envy (Dushnitsky & Shapira, 2010; Nickerson & Zenger, 2008; Obloj & Zenger, 2017), so that large corporations may prefer to allocate investments based, at least in part, on the basis of equity rather than underlying opportunity (Arrfelt et al., 2013; Bardolet et al., 2011). Second, as the strategy literature has long recognized, a key rationale for firm diversification is to realize economies of scope from the sharing of resources and capabilities across businesses (Penrose, 1959; Teece, 1980)—it follows that the strategic assets of an individual business within a diversified firm may not be independent of the assets of the parent, but rather defined and constrained by the parent's assets. As a result, businesses for which the level of long-term investments⁶ by their rivals exceeds the average investment level of the parent may be especially susceptible to underinvestment. Thus:

Hypothesis 2a (H2a) *Divested businesses whose rivals' R&D intensity is greater than that of their parents are more likely to be acquired by PE firms than by corporate acquirers compared to those whose rivals' R&D intensity is less than that of their parents.*

Hypothesis 2b (H2b) *Divested businesses whose rivals' long-term capital investments are greater than those of their parents' are more likely to be acquired by PE firms than by corporate acquirers compared to those whose rivals' long-term capital investments are less than those of their parents.*

2.4 | Weak and misaligned incentives

Finally, we turn to consider the incentive problems associated with public ownership. To begin with, as already mentioned, excessive pressure from public equity markets may cause managers to behave myopically: not only may they underinvest in long-term strategic assets (Graham et al., 2005; Zhang & Gimeno, 2010), they may also compromise long-term performance in other ways, for example, by undertaking less maintenance or making excessive use of existing assets (Williamson, 1985). These tendencies may be partially offset by the provision of appropriate long-term incentives—such as stock options or stock ownership—which may better align managerial interests with those of shareholders, increasing managerial willingness to invest in long-term assets (Baysinger et al., 1991; Holthausen, Larcker, & Sloan, 1995; Kor, 2006; Sanders, 2001), and potentially improving firm performance (Carpenter & Sanders, 2002; Finkelstein & Hambrick, 1988; Holthausen & Larcker, 1996). However, such high-powered incentives may themselves lead to unintended adverse consequences (Williamson, 1985), such as excessive risk-taking by managers (Sanders & Hambrick, 2007), unless they are properly designed (Makri, Lane, & Gomez-Mejia, 2006) and accompanied by active and informed monitoring by corporate boards (Kor, 2006; Wright, Kroll, & Elenkov, 2002; Walters, Kroll, & Wright, 2008). High-powered incentives linked to stock market performance may be especially problematic given the cognitive limitations of equity market investors (Barberis & Thaler,

⁶The appropriate level of long-term investment in a business is, of course, hard to measure ex ante from the outside—again, this is part of the reason for underinvestment. Our use of industry average investments as a proxy for a business's investment opportunities is in line with existing work that examines the efficiency of corporate investment allocation (Arrfelt et al., 2013, 2015).

2003; Shiller, 2003), so that making managerial compensation responsive to market prices may lead to decisions that are subject to the investors' biases and susceptible to manipulation by self-seeking managers (Campbell et al., 2016; Graffin, Halebian, & Kiley, 2016; Schijven & Hitt, 2012).

In comparison, PE firms may have several advantages in providing high-powered managerial incentives (Jensen, 1989; Phan & Hill, 1995; Wiersema & Liebeskind, 1995), being able to offer incentives that are both longer-term (Guo et al., 2011; Holthausen & Larcker, 1996), and more closely linked to the stand-alone business (Feldman, 2016; Holthausen et al., 1995). More importantly, PE firms may also have stronger incentives as owners. As long-term investors whose payouts are strongly linked to the business's eventual success (and therefore its value at exit), PE fund managers typically have very strong incentives to ensure the success of their deals (Wiersema & Liebeskind, 1995)—much stronger, for instance, than the average corporate board member—making them ideally capable of subjecting the businesses they acquire to more vigilant monitoring (Cotter & Peck, 2001; Hertzel & Smith, 1993).

It follows that PE firms will systematically target businesses whose parents provide weak incentives to their executives. Weak incentives at the overall parent level may not only be associated with a general firm-wide tendency for the firm to underinvest in long-term performance, but top management teams who have weak incentives may be more lax in monitoring and correcting their subordinates, so that the underinvestment and agency problems at the divisional level in such organizations may be more severe. Divestments from such firms are therefore likely to offer substantial opportunities for PE firms to improve long-term performance by introducing high-powered incentives.

While the argument above focuses on the problem of weak managerial incentives at the parent level, a second issue with large public corporations is that strong incentives at the top may not translate into strong incentives at lower levels (Carpenter & Sanders, 2002). First, to the extent that key strategic decisions about long-term investments and resource allocations in M-form corporations are made at the corporate center (Williamson, 1985), it is logical that the corresponding incentives be concentrated at the corporate level as well. Second, even if the organization were to give divisional managers both the incentive and the authority to make long-term investments independent of corporate oversight, this may result in logrolling and other opportunistic actions by divisional managers, effectively undermining the coordination across businesses that was the purpose of placing them under a common hierarchy in the first place (Williamson, 1985, 1991). Third, given differences between business lines, offering high-powered incentives to divisional managers may require firms to offer different incentives to different businesses, but such differences may put a severe strain on the organization (Williamson, 1985) as they may result in intra-organizational envy and comparison costs (Dushnitsky & Shapira, 2010; Nickerson & Zenger, 2008; Obloj & Zenger, 2017). Fourth, even if the organization were to offer high-powered incentives to its divisional managers, these may prove less effective, since such incentives would typically be based on the performance of the firm overall, with the divisional managers' actions having only a limited impact on their eventual payouts (Feldman, 2016; Holthausen et al., 1995). Moreover, even with high-powered incentives, divisional managers in large corporations may evaluate risky long-term investments based on internal comparisons with other units within the organization (Eggers & Kaul, 2017; Kacperczyk, Beckman, & Moliterno, 2015), creating the potential for misalignment. For all these reasons, "high powered incentives in firms are subject to degradation" (Williamson, 1985, p. 142). In terms of target selection, this suggests that PE firms may

systematically target businesses whose parents offer weaker long-term incentives to their divisional executives than to their corporate executives.⁷

Note that the same factors that enable PE firms to offer more effective high-powered incentives than the business's corporate parent, also give them an advantage relative to other corporate acquirers. Such corporate acquirers are likely to suffer from the same constraints as the business's erstwhile parent, both in offering high-powered incentives and in designing and monitoring them (Williamson, 1985). Further, the incentives of the managers of acquired businesses may be further impaired to the extent that subsequent pay and promotion benefits are determined by political processes that are tilted in the favor of the acquiring firm's managers (Williamson, 1985). In addition, even if the acquiring firm were willing to offer aggressive stock-based incentives to target managers, these would still be less effective than those under PE ownership, being based on the performance of the combined firm postacquisition, rather than the target's own performance (Feldman, 2016; Holthausen et al., 1995). For all these reasons, we predict:

Hypothesis 3 (H3) *The weaker the long-term incentives of a parent's top executives before divestment, the greater the probability that a business divested by it will be acquired by a private equity firm than by a corporate acquirer.*

Hypothesis 4 (H4) *The weaker the long-term incentives of divisional executives of a parent relative to its corporate executives prior to divestment, the greater the likelihood that a business divested by it will be acquired by a private equity firm than by a corporate acquirer.*

3 | DATA AND METHODS

We test our hypotheses in a sample of divestments by publicly listed U.S. manufacturing firms from 1997 to 2010. Data on divestments are drawn from the Securities Data Company (SDC) Platinum database. We begin with all divestments in the U.S. manufacturing sector (SIC 2000-3999) listed in the SDC database for our sample years. These are then matched to parent corporations in Compustat, thus limiting our sample to divestments by publicly listed firms. We then match the remaining transactions to the Execucomp database, since we need data on executive compensation and ownership. Our final sample consists of 1,711 divestments.

3.1 | Measures

Our main dependent variable *PE buyout* is a binary measure that takes the value 1 if the acquirer of the divested business was a private equity firm, and 0 otherwise.⁸ We consider an acquirer to be a

⁷Strictly speaking, the argument above suggests that PE firms should specifically target businesses whose managers have weak incentives relative to executives at the corporate center. Unfortunately, we are unable to determine the compensation of the executives managing the specific business that was divested, so we rely instead on the general gap between corporate and divisional managers. This seems reasonable given the arguments above about the need for equity of incentives across divisions.

⁸Our final sample includes 48 divestments where the acquirer is a non-PE financial buyer or investor group. None of these acquirers are classified as private equity by SDC, nor are they the kind of dedicated buyout firms that are the focus of our theory. We therefore classify these acquirers as (unrelated) corporate buyers in our main analysis, though excluding them from our analysis does not significantly alter our findings.

private equity firm if they are so classified by SDC, though we confirm this classification by checking each buyer's identity using Internet searches.

Turning to independent variables, our *NonCore* measure takes the value of 1 if the SIC code of the divested business differs from the parent's primary industry (Kaul, 2012) at the two-digit SIC code level (Bergh et al., 2008), though results using three-digit or four-digit SIC comparisons are similar.

We measure *Rival R&D Intensity Higher than Parent* as a binary variable that takes a value of 1 if the average R&D intensity (i.e., the ratio of R&D spending to sales) of firms in the divested unit's industry (defined at the two-digit SIC level) is greater than the parent firm's R&D intensity, and 0 otherwise. This measure thus captures the level of R&D spending by the divested business's rivals relative to its parent. We use a binary measure in part because our hypothesis is about whether the divested business's optimal R&D intensity is greater than its parent's, not how much greater it is, and in part because our measure itself is relatively crude, so we would not expect differences in magnitude to be significant. That said, results using a continuous measure are similar (not shown, but available on request).⁹

We use a similarly constructed binary measure *Rival New Asset Durability Higher than Parent* to compare the new asset durability of the divested business's rivals to that of its parent. New asset durability itself is calculated as the average expected life of new capital assets by dividing capital expenditure in a year by the portion of the depreciation expense attributable to this capital expenditure (for details on the logic behind, and calculation of, this measure, see Souder & Bromiley, 2012). As with our R&D measure, our results are similar if we use a continuous measure of new asset durability difference.

To measure the strength of managerial incentives, we follow prior literature (He & Wang, 2009) and construct a measure of *Parent Executive Long-term Compensation*, which is the ratio of the long-term elements of executive compensation (specifically, stock options plus long-term incentive plans) to total executive compensation. We calculate this measure for each member of the top management team as listed in the Execucomp database, and then average across the team, using the individual compensation as weights. Given our focus on divestments, we are less interested in the incentives of the CEO than in those of the executives reporting to him or her; we therefore follow work that has stressed the distinction between CEO and top management team compensation (Carpenter & Sanders, 2002) by excluding the CEO's compensation from our main predictor, though we include *CEO Long-term Compensation* separately as a control. Because compensation levels may vary across industry and time, and because executive compensation is explicitly determined with reference to peers in their primary industry (Porac, Wade, & Pollock, 1999)—a comparison that is likely to impact the incentive effects of such compensation—we industry-adjust our measure of executive long-term compensation by subtracting from it the average long-term compensation of executives in the same primary industry as the parent (defined at the two-digit SIC level). While we believe this adjustment is important, the results reported below are robust to the use of nonindustry-adjusted measures.

In addition, we measure the *Parent Corporate vs. Divisional Executive Long-term Compensation Difference* as the gap between the average long-term compensation of those executives who are listed as "C-level" executives (such as the CEO, CFO, CIO, corporate counsel, or other similar positions) and those of executives who do not possess corporate-level titles, and are instead listed as, for

⁹We test the robustness of our results using Research Quotient (RQ)—a recently developed measure of the elasticity of firm revenue with respect to R&D spending (see Cooper, Knott, & Yang, 2015; Knott, 2008, for details)—and confirm that our results are robust to this alternate measure (results available upon request).

example, divisional or executive managers in the Execucomp database. To reduce problems of correlation between this measure and our overall executive compensation measure, we divide the difference between corporate and divisional long-term compensation by the level of corporate long-term compensation. Higher values of this measure thus imply weaker long-term incentives for divisional executives relative to corporates executives.

In addition to these main variables of interest, we include a number of controls, starting with characteristics of the parent firm. First, *Parent Operating Return* is measured as the ratio of operating profit (Earnings before interest, tax, depreciation, and amortization) to total revenues of the parent. Second, we also include measures of *Parent Size* (measured as the log of firm revenues) and *Parent Diversification* (measured as one minus the Herfindahl index of the parent firm sales across businesses, using segment data from Compustat). Third, we include measures of organizational slack (Tan & Peng, 2003), distinguishing between *Parent Potential Slack*, *Parent Available Slack*, and *Parent Unavailable Slack*, measured as one minus the ratio of debt to enterprise value, cash and short-term investments over enterprise value, and noncash assets (inventories and receivables less accounts payable) over enterprise value, respectively. Fourth, we include a control for the extent of *Parent Capital Expenditure*, calculated as the ratio of the firm's capital expenditure to its total revenues in a given year. Fifth, as mentioned above, we include a control for *Parent CEO Long-term Compensation*, as well as a control for *Parent Executive Share Ownership*, measured as the ratio of shares owned by executives to the total number of outstanding shares of common stock. Sixth, as some firms may develop divesting capabilities over time (Bingham, Heimiriks, Schijven, & Gates, 2015; Moliterno & Wiersema, 2007), we also include a measure of *Parent Divestiture Experience* as the number of divestitures by the parent firm over the prior 5 years. Since prior experience with one type of corporate development activity may have learning benefits for other types (Zollo & Reuer, 2010), we also include controls for *Parent Acquisition Experience* and *Parent Alliance Experience*. Seventh, a small number of our observations do not report R&D, in which case we assume it to be zero. We control for such observations with *Missing Parent R&D Intensity*. In unreported robustness checks (available on request) we also confirm that our results for the effect of R&D intensity on PE acquisition are robust to dropping all observations with missing R&D. Eighth, we account for characteristics of the divested unit's industry, including controls for *Business Industry Average R&D Intensity*, *Business Industry New Asset Durability*, *Business Industry Average Executive Long-Term Compensation*, and *Missing Unit Industry R&D Intensity*, all measured as the yearly average of the relevant measure (constructed in the manner described above) for the entire sample of public firms in the same industry (at the two-digit SIC level) as the divested unit available from Compustat. Ninth, we include a control for the *Treasury Rate*, measured as market yield on U.S. treasury securities at 10-year constant maturity, quoted on investment basis. Finally, all models include year fixed effects to account for variations over time. All relevant independent variables have been lagged by a year and Winsorized at the 99% level where necessary.¹⁰ Table 1 provides summary descriptions of all variables used in our main analysis, and Tables 2 and 3 show the summary statistics and correlations for our variables, respectively. While there are a few high correlations, the mean VIF is only 1.49, with no individual VIF being greater than 2.37, suggesting that collinearity is not a serious concern (Belsley, 1991).

¹⁰Winsorized variables are parent-level financial statistics and ratios, specifically *Operating Return*, *Potential Slack*, *Available Slack*, *Unavailable Slack*, *Capital Expenditure*, *R&D Intensity*, and *Executive Share Ownership*.

TABLE 1 Measures

Variable	Description	Source
<i>NonCore</i>	Relatedness of divested business to parent's primary SIC code at the two-digit level, takes a value of 1 if different, 0 otherwise	Securities Data Company (SDC) Platinum
<i>Rival R&D Intensity Higher than Parent</i>	Whether the divested business industry average R&D intensity is higher than that of parent firm's, where R&D intensity is ratio of R&D spending to sales (binary)	Compustat
<i>Rival New Asset Durability Higher than Parent</i>	Whether divested business industry average new asset durability (NAD) is greater than parent firm's, where NAD is measured as annual capital expenditure divided by the portion of depreciation attributable to it (binary)	Compustat
<i>Parent Executive Long-Term (LT) Compensation</i>	Averaged annual ratio of the top management team's long-term incentive plans and stock options to total compensation (relative to industry peers)	Execucomp
<i>Parent Corporate vs. Divisional Executive LT Compensation Difference</i>	Difference between the annual ratio of the C-level executive managers' and non C-Level executive managers' LTC as the ratio of the difference between the two over the C-level LTC compensation	Execucomp
<i>Parent Operating Return</i>	Ratio of operating profit to total revenues of the parent firm	Compustat
<i>Parent Size</i>	Firm revenues in millions, USD (logged)	Compustat
<i>Parent Diversification</i>	One minus Herfindahl index of the parent firm sales across business segments	Compustat
<i>Parent Potential Slack</i>	One minus the ratio of debt to enterprise value	Compustat
<i>Parent Available Slack</i>	Cash and short-term investments over enterprise value	Compustat
<i>Parent Unavailable Slack</i>	Noncash assets over enterprise value	Compustat
<i>Parent Capital Expenditure Ratio</i>	Capital expenditures over total revenues	Compustat
<i>Parent CEO Long-Term Compensation</i>	Averaged annual ratio of the CEO's long-term incentive plans and stock options to total compensation	Execucomp
<i>Parent Executive Share Ownership</i>	Ratio of executive-owned shares to total number of outstanding common stock shares	Execucomp
<i>Parent Divestiture Experience</i>	Number of divestitures by parent over the previous 5 years	Securities Data Company (SDC) Platinum
<i>Parent Acquisition Experience</i>	Number of acquisitions by parent over the previous 5 years	Securities Data Company (SDC) Platinum
<i>Parent Alliance Experience</i>	Number of alliances by parent over the previous 5 years	Securities Data Company (SDC) Platinum
<i>Business Industry Avg. R&D Intensity</i>	Divested business industry average R&D intensity, where R&D intensity is measured as ratio of R&D spending to sales	Compustat
<i>Business Industry Avg. New Asset Durability</i>	Divested business industry average new asset durability (NAD), where NAD is measured as annual capital expenditure divided by the portion of the depreciation expense attributable to it	Compustat

TABLE 1 (Continued)

Variable	Description	Source
<i>Business Industry Avg. Executive Long-Term Compensation</i>	Divested business industry average annual ratio of the top management team's long-term incentive plans and stock options (LTC) to total compensation	Execucomp
<i>Missing Parent RD Intensity</i>	Dummy for whether parent's RD intensity ratio is not available	Compustat
<i>Missing Business Industry Average RD Intensity</i>	Dummy for whether business industry average RD intensity ratio is not available	Compustat
<i>US Treasury Rate</i>	Annual market yield (ratio) on U.S. treasury securities at 10-year constant maturity	U.S. Dept. of the Treasury

TABLE 2 Summary statistics

Variable	Median	Mean	SD	Min	Max
<i>PE</i> (private equity)	0.00	0.11	0.31	0.00	1.00
<i>NonCore</i>	0.00	0.50	0.50	0.00	1.00
<i>Rival Average R&D Intensity Higher than Parent</i>	1.00	0.79	0.40	0.00	1.00
<i>Rival Average New Asset Durability Higher than Parent</i>	0.00	0.18	0.38	0.00	1.00
<i>Parent Executive Long-Term (LT) Compensation</i>	0.05	0.05	0.16	-0.66	0.51
<i>Parent Corporate vs. Divisional Executive LT Comp. Difference</i>	0.07	-0.40	13.84	-633.25	1.00
<i>Parent Operating Return</i>	0.14	0.14	0.18	-1.84	0.46
<i>Parent Size</i>	8.37	8.35	1.66	0.30	12.72
<i>Parent Diversification</i>	0.55	0.47	0.28	0.00	1.00
<i>Parent Potential Slack</i>	0.61	0.58	0.22	-0.04	0.98
<i>Parent Available Slack</i>	0.04	0.08	0.13	0.00	1.13
<i>Parent Unavailable Slack</i>	0.12	0.14	0.10	-0.01	0.62
<i>Parent Capital Expenditure Ratio</i>	0.17	0.20	0.14	0.03	1.43
<i>Parent CEO LT Compensation</i>	0.68	0.62	0.25	0.00	1.00
<i>Parent Executive Share Ownership</i>	0.00	0.00	0.00	0.00	0.00
<i>Parent Divestiture Experience</i>	3.00	5.89	7.97	0.00	48.00
<i>Parent Acquisition Experience</i>	7.00	11.56	13.57	0.00	101.00
<i>Parent Alliance Experience</i>	3.00	15.32	36.04	0.00	287.00
<i>Business Industry Avg. R&D Intensity</i>	0.10	0.10	0.07	0.00	0.26
<i>Business Industry Avg. New Asset Durability</i>	-0.56	-0.69	0.47	-5.60	0.08
<i>Business Industry Avg. Executive Long-Term Compensation</i>	0.41	0.39	0.09	0.00	0.70
<i>Missing Parent RD Intensity</i>	0.00	0.20	0.40	0.00	1.00
<i>Missing Business Industry Average RD Intensity</i>	0.00	0.04	0.21	0.00	1.00
<i>US Treasury Rate</i>	0.05	0.05	0.01	0.04	0.07

TABLE 3 Correlations

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24
1 <i>PE</i>	1.00																							
2 <i>NonCore</i>	0.05	1.00																						
3 <i>Rival Average R&D Intensity Higher than Parent</i>	0.02	-0.08	1.00																					
4 <i>Rival Average New Asset Durability Higher than Parent</i>	0.05	0.06	-0.14	1.00																				
5 <i>Parent Executive</i>	-0.06	0.01	-0.09	0.00	1.00																			
<i>Long-Term (LT) Compensation</i>																								
6 <i>Parent Corporate vs. Divisional Executive LT Comp. Difference</i>	0.01	0.02	-0.02	0.01	0.01	1.00																		
7 <i>Parent Operating Return</i>	0.02	-0.08	0.14	-0.03	0.09	0.01	1.00																	
8 <i>Parent Size</i>	0.08	0.02	0.07	-0.09	0.30	0.02	0.41	1.00																
9 <i>Parent Diversification</i>	0.07	0.13	0.14	-0.06	0.11	-0.02	0.11	0.47	1.00															
10 <i>Parent Potential Slack</i>	0.00	0.00	-0.09	0.08	0.08	0.04	0.31	0.06	-0.11	1.00														
11 <i>Parent Available Slack</i>	-0.05	-0.06	-0.18	0.07	-0.04	0.00	-0.36	-0.36	-0.24	-0.12	1.00													
12 <i>Parent Unavailable Slack</i>	0.00	0.08	0.12	-0.01	-0.20	-0.04	-0.21	-0.27	-0.02	-0.40	0.12	1.00												
13 <i>Parent Capital Expenditure Ratio</i>	-0.03	0.04	-0.09	0.32	0.04	0.01	0.04	-0.10	-0.20	0.26	0.08	-0.04	1.00											
14 <i>Parent CEO LT Compensation</i>	0.01	-0.04	-0.11	0.06	0.52	0.08	0.11	0.30	0.12	0.13	0.04	-0.22	0.09	1.00										
15 <i>Parent Executive Share Ownership</i>	0.02	0.01	0.03	0.01	-0.15	0.00	-0.06	-0.09	-0.01	0.04	0.17	0.00	-0.19	1.00										

TABLE 3 (Continued)

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24
16 Parent Divestiture	-0.01	0.03	0.03	-0.10	0.22	0.01	0.14	0.55	0.37	0.03	-0.12	-0.16	-0.12	0.18	-0.14	1.00								
17 Parent Acquisition	0.02	0.12	0.07	-0.05	0.17	0.01	0.12	0.39	0.37	0.07	-0.06	-0.07	-0.07	0.22	-0.09	0.42	1.00							
18 Parent Alliance	-0.02	0.05	-0.01	-0.01	0.12	0.01	0.08	0.40	0.16	0.16	-0.04	-0.10	0.15	0.16	-0.09	0.51	0.23	1.00						
19 Business Industry	-0.10	-0.19	0.21	-0.18	0.07	0.02	0.05	0.02	-0.05	0.17	0.18	-0.14	0.08	0.17	-0.03	0.12	0.08	0.15	0.00	0.55	-0.13	1.00		
20 Business Industry	0.07	-0.14	-0.01	0.23	-0.04	-0.01	0.01	0.06	0.13	-0.18	-0.05	-0.02	-0.33	0.00	0.02	-0.06	-0.20	-0.23	1.00					
21 Business Industry	-0.01	-0.11	0.10	-0.05	0.00	0.03	0.05	0.05	0.01	0.13	0.12	-0.12	0.07	0.26	-0.05	0.03	0.06	0.00	0.55	-0.13	1.00			
22 Missing Parent RD	-0.02	-0.04	0.18	0.03	-0.11	0.01	-0.03	-0.03	-0.14	-0.05	-0.12	-0.08	0.11	-0.10	-0.21	0.14	-0.16	-0.13	-0.30	0.17	-0.26	0.16	1.00	
23 Missing Business	0.00	0.04	0.11	0.06	-0.05	0.00	-0.01	0.01	0.07	-0.08	-0.02	0.04	-0.06	-0.08	0.02	-0.02	-0.04	-0.04	-0.04	0.12	0.01	0.26	-0.09	
24 US Treasury Rate	-0.09	0.12	-0.03	-0.07	0.05	0.00	-0.03	-0.05	-0.13	0.10	-0.16	0.02	0.23	-0.21	0.04	0.12	0.01	0.26	-0.09	-0.36	-0.41	0.00	-0.01	

3.2 | Methods

Given the binary nature of our dependent variable, we use a probit model, predicting the likelihood of private equity buyout as a function of our main predictors and controls, with the individual divestment as our unit of analysis.¹¹ Where the parent firm divests multiple businesses at the same time, we treat these as separate observations, but cluster our standard errors by parent firm to account for the nonindependence of such observations.

A key concern with our analysis is the endogenous nature of the parent's decision to divest, which may bias the sample of divestments that we observe. In particular, the very factors that are predicted to drive PE buyout—unrelatedness of the business, investment intensity, and managerial incentives—may also impact the firm's decision to divest (Bergh et al., 2008; Bergh & Lawless, 1998; Kaul, 2012; Villalonga & McGahan, 2005). To account for this potential sample selection bias, we use a two-stage procedure. In the first stage, we predict the likelihood of a firm undertaking a divestment in a given year as a function of all firm-level predictors included in our main models, running a probit model on an unbalanced panel of firm-level attributes for our parent firms from 1997 to 2010.¹² We then use this predicted probability of divestment to calculate an inverse Mills ratio, which we include as an endogeneity correction in our (main) probit regressions predicting PE buyout (Heckman, 1979).¹³ As an instrument in the first stage we use the level of divestment activity by other firms in the parent firm's industry—that is, the number of divestments in a year by all firms in the parent's two-digit SIC code, excluding the parent firm itself—the logic being that bandwagon effects in corporate transactions (Brauer & Wiersema, 2012) will result in an increased probability of divestment, but should not impact the likelihood of any given divestment being bought by a PE firm.

4 | RESULTS

4.1 | Main Findings

The results of our main analysis are shown in Models I–III of Table 4. All models in Table 4 are estimated using the *probit* procedure in Stata 13. Model I is our first-stage regression-predicting selection into divestment, and shows a positive effect ($p < .001$) of our instrument on the likelihood of divestment. In addition, consistent with prior work (Bergh & Lawless, 1998; Kaul, 2012; Villalonga & McGahan, 2005), it shows that larger and more diversified firms are more likely to divest, as are firms with low potential slack, high R&D intensity, and high levels of acquisition and divestment experience.

Models II and III predict the likelihood that, conditional on being divested, a business is sold to a PE firm (rather than a corporate acquirer), where Model II is the base model with all controls. Model II shows that PE firms are more likely to buy divested businesses from larger parents ($p = .008$). It also shows limited statistical significance for our endogeneity correction ($p = .147$), suggesting that selection may not be too serious a concern in our context.

¹¹We choose a probit model rather than a logit because we use a Heckman correction to account for the endogeneity of divestment choice. Results from using a logit model are shown in the supplementary analysis section and are similar to those from a probit model. Main models are estimated using the *probit* command in Stata 13, with robust standard errors clustered at the parent firm level.

¹²Additionally, we similarly predict the likelihood of the firm undertaking a core or a noncore divestment and use the latter as a first stage in supplementary analysis described below (See Models IV and VI, respectively, in Table 4).

¹³This procedure is essentially identical to the *heckprobit* command available in Stata, except that each observation in our first-stage model potentially maps to multiple observations in the second stage.

TABLE 4 Main results

	All investments							Core divestments			Non-core divestments		
	I			II		III		IV		V		VI	
	0.015 (.000)			0.011 (.002)				0.011 (.002)				0.492 (.008)	
<i>Industry Divestment Activity (Stage 1 Instrument)</i>													
<i>NonCore</i>													
<i>Rival R&D Intensity Higher than Parent</i>													
<i>Rival New Asset Durability Higher than Parent</i>													
<i>Parent Executive Long-Term (LT) Compensation</i>	0.149 (.302)												
<i>Parent Corporate vs. Divisional Executive LT Comp. Difference</i>	-0.001 (.328)												
<i>Parent Operating Return</i>	0.486 (.013)												
<i>Parent Size</i>	0.088 (.000)												
<i>Parent Diversification</i>	0.569 (.000)												
<i>Parent Potential Slack</i>	-0.457 (.000)												
<i>Parent Available Slack</i>	-0.114 (.429)												
<i>Parent Unavailable Slack</i>	0.081 (.753)												
<i>Parent Capital Expenditure Ratio</i>	-0.188 (.085)												
<i>Parent CEO LT Compensation</i>	0.128 (.211)												
<i>Parent Executive Share Ownership</i>	-5.660 (.126)												
<i>Parent Divestiture Experience</i>	0.052 (.000)												
<i>Parent Acquisition Experience</i>	0.015 (.000)												
<i>Parent Alliance Experience</i>	0.001 (.860)												
<i>Parent New Asset Durability</i>	-0.004 (.729)												
<i>Parent R&D Intensity</i>	0.645 (.000)												
<i>Business Industry Avg. R&D Intensity</i>													
<i>Business Industry Avg. New Asset Durability</i>													
<i>Business Industry Avg. Executive Long-Term Compensation</i>													
<i>Missing Parent RD Intensity</i>	-0.202 (.001)												

TABLE 4 (Continued)

	All divestments			Core divestments			Non-core divestments	
	I	II	III	IV	V	VI	VII	
<i>Missing Business Industry Average RD Intensity</i>		-0.246 (.251)	-0.375 (.082)		-0.130 (.587)			-0.790 (.014)
<i>US Treasury Rate</i>	10,101 (.011)	-13,146 (.318)	-13,062 (.330)	6,822 (.132)	-19,070 (.233)	15,653 (.001)	-4,083 (.822)	
<i>Inverse Mills' Ratio</i>	0.509 (.147)	0.375 (.290)		0.221 (.571)			0.087 (.814)	
N	7892	1711	7892	905	7892	806		
Log-likelihood	-2804.998	-567.7	-558.267	-2134.45	-260.79	-1796.39	-276.42	
Year effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	

Note. Dependent variable in first stage models (I, IV, and VI) takes value 1 if firm divests in the subsequent year. Dependent variable in second stage models (II, III, V, and VII) takes the value 1 if acquirer is private equity. All models include a constant term and robust standard errors clustered by parent firm. Figures in parentheses are *p* values.

TABLE 5 Supplementary analysis

	VIII Full logit	IX			X			XI			XII		
	Rel. corp 792	Unrel. corp 731	Exp. corp 363	Inexp. corp 1160	Private corp 445	Public corp 1,078	Foreign corp 608	Public corp 1,078	Private corp 445	Foreign corp 608	US corp 915		
<i>NonCore</i>	-0.351 (.041)	-0.557 (.002)	-0.147 (.421)	-0.230 (.273)	-0.388 (.027)	-0.404 (.024)	-0.323 (.078)	-0.289 (.137)	-0.391 (.023)				
<i>Rival R&D Intensity Higher than Parent</i>	-0.478 (.027)	-0.638 (.006)	-0.319 (.159)	-0.366 (.140)	-0.511 (.022)	-0.439 (.064)	-0.498 (.028)	-0.516 (.029)	-0.453 (.041)				
<i>Rival NAD Higher than Parent</i>	-0.239 (.3334)	-0.299 (.254)	-0.186 (.480)	-0.406 (.155)	-0.185 (.467)	-0.293 (.292)	-0.218 (.391)	-0.224 (.393)	-0.248 (.339)				
<i>Parent Exec. Long-Term Compensation (LTC)</i>	1.141 (.058)	1.084 (.100)	1.187 (.049)	1.774 (.014)	0.952 (.116)	1.054 (.105)	1.172 (.062)	1.193 (.065)	1.102 (.076)				
<i>Parent Corp. vs. Div. Exec. LTC Difference</i>	-0.317 (.103)	-0.318 (.099)	-0.313 (.105)	-0.313 (.107)	-0.316 (.104)	-0.285 (.155)	-0.331 (.091)	-0.317 (.105)	-0.320 (.102)				
<i>Parent Operating Return</i>	0.600 (.341)	0.845 (.030)	0.201 (.763)	1.474 (.081)	0.462 (.482)	0.356 (.574)	0.715 (.297)	0.834 (.262)	0.511 (.416)				
<i>Parent Size</i>	-0.205 (.009)	-0.044 (.465)	-0.193 (.015)	-0.174 (.056)	-0.213 (.008)	-0.229 (.004)	-0.190 (.025)	-0.170 (.043)	-0.230 (.005)				
<i>Parent Diversification</i>	0.023 (.951)	0.134 (.561)	-0.037 (.925)	-0.091 (.829)	0.079 (.834)	0.102 (.807)	-0.005 (.989)	0.094 (.817)	-0.024 (.948)				
<i>Parent Potential Slack</i>	-0.613 (.185)	0.160 (.603)	-0.711 (.152)	-1.178 (.023)	-0.451 (.342)	-0.616 (.234)	-0.616 (.198)	-0.810 (.105)	-0.490 (.301)				
<i>Parent Available Slack</i>	1.142 (.318)	-0.187 (.706)	1.206 (.299)	1.472 (.243)	1.055 (.358)	1.180 (.313)	1.139 (.329)	1.256 (.277)	1.059 (.372)				
<i>Parent Unavailable Slack</i>	-0.301 (.753)	-0.408 (.539)	-0.121 (.900)	-0.440 (.695)	-0.236 (.809)	-0.014 (.989)	-0.463 (.649)	-0.424 (.685)	-0.185 (.848)				
<i>Parent Capital Expenditure Ratio</i>	-0.106 (.892)	-0.052 (.906)	-0.094 (.909)	0.125 (.890)	-0.189 (.809)	-0.374 (.660)	0.015 (.286)	0.012 (.988)	-0.197 (.801)				
<i>Parent CEO LT Compensation</i>	-0.279 (.574)	0.170 (.556)	-0.386 (.448)	-0.461 (.407)	-0.231 (.645)	-0.364 (.485)	-0.242 (.638)	-0.406 (.433)	-0.187 (.715)				
<i>Parent Exec. Share Ownership</i>	-25.737 (.177)	-20.583 (.115)	-17.551 (.356)	-14.501 (.501)	-29.740 (.122)	-23.110 (.229)	-26.521 (.191)	-27.108 (.200)	-24.921 (.196)				
<i>Parent Divestiture Experience</i>	0.015 (.271)	-0.005 (.558)	-0.015 (.301)	0.016 (.271)	0.014 (.315)	0.014 (.357)	0.015 (.286)	0.019 (.173)	0.011 (.414)				
<i>Parent Acquisition Experience</i>	-0.002 (.763)	-0.003 (.704)	-0.001 (.907)	0.004 (.590)	-0.004 (.525)	-0.005 (.494)	-0.001 (.950)	-0.005 (.392)	0.001 (.935)				
<i>Parent Alliance Experience</i>	-0.001 (.978)	-0.001 (.813)	0.001 (.866)	0.001 (.954)	-0.001 (.960)	-0.002 (.551)	0.001 (.947)	0.001 (.895)	-0.001 (.876)				
<i>Business Ind. Avg. R&D Intensity</i>	3.955 (.930)	6.520 (.001)	1.176 (.542)	2.887 (.184)	4.264 (.018)	2.435 (.182)	4.775 (.014)	4.333 (.031)	3.705 (.041)				
<i>Business Ind. Avg. New Asset Durability</i>	-0.134 (.567)	-0.080 (.751)	-0.214 (.377)	-0.085 (.747)	-0.153 (.521)	0.012 (.955)	-0.192 (.421)	-0.091 (.711)	-0.166 (.497)				
<i>Business Industry Avg. Exec. LT Compensation</i>	1.317 (.483)	1.220 (.536)	1.447 (.444)	1.236 (.530)	1.350 (.483)	2.097 (.296)	0.818 (.665)	1.327 (.470)	1.293 (.521)				
<i>Missing Parent RD Intensity</i>	0.583 (.113)	6.520 (.001)	0.475 (.227)	0.676 (.116)	0.553 (.130)	0.583 (.136)	0.578 (.133)	0.692 (.085)	0.512 (.164)				
<i>Missing Business Industry Average RD Intensity</i>	0.675 (.097)	0.883 (.064)	0.476 (.211)	0.526 (.225)	0.719 (.103)	0.808 (.066)	0.571 (.192)	0.887 (.040)	0.487 (.269)				
<i>US Treasury Rate</i>	33.515 (.165)	37.223 (.149)	29.644 (.225)	31.763 (.260)	34.018 (.156)	43.481 (.091)	29.429 (.236)	24.193 (.330)	39.486 (.116)				

TABLE 5 (Continued)

	IX			X			XI			XII		
	VIII		Rel. corp	Unrel. corp	Exp. corp	Inexp. corp	Private corp	Public corp	Private corp	Public corp	Foreign corp	US corp
	Full	logit	792	731	363	1160	445	1,078	608	608	915	915
Base Acquirer Type	PE	Private Equity Acq.		Private Equity Acq.		Private Equity Acq.		Private Equity Acq.		Private Equity Acq.		Private Equity Acq.
N (Total)	1711	1711		1711		1711		1711		1711		1711
Log-likelihood	-558.83	-1562.08		-1572.53		-1372.53		-1431.79		-1431.79		-1556.57
Year effects	Yes	Yes		Yes		Yes		Yes		Yes		Yes

Note. All models except for Model VIII are mlogit regressions. Dependent variables take on differing values depending on acquirer type. All models include a constant term and robust standard errors clustered by parent firm. Figures in parentheses are *p* values. Numbers below acquirer types are instances of that type in the sample.

Model III is the main model of interest, and includes our main predictors. Consistent with our theory, it shows that our *NonCore* measure enters the regression with a positive coefficient ($p = .049$), implying that PE firms are more likely to buy noncore businesses than core businesses. In terms of economic significance,¹⁴ noncore businesses are 31.3% more likely to be bought by PE firms than core businesses. Hypothesis 1 is thus supported.

Turning to Hypotheses 2a and 2b, the coefficient of *Rival R&D Intensity Higher than Parent* in Model III is strongly positive ($p = .027$), implying that PE firms are more likely to buy businesses whose rivals spend more on R&D than their parents. In economic terms, divested businesses whose rivals have a higher R&D intensity than their parents are 50.2% more likely to be bought by PE firms than those whose parents outspend their rivals. Model III thus offers strong support for Hypothesis 2a. We do not, however, find support for Hypothesis 2b. While the coefficient of *Rival New Asset Durability Higher than Parent* is positive (as predicted), the statistical significance of the result is low ($p = .357$).

Model III also shows support for Hypothesis 3, with our measure of *Executive Long-term Compensation* entering the regression with a negative coefficient ($p = .040$). PE firms are 40.2% more likely to buy businesses divested from parents whose long-term executive compensation is one standard deviation below the sample mean than from those whose compensation is one standard deviation above the sample mean.

Finally, our measure of *Parent Corporate vs. Divisional Executive Long-term Compensation Difference* takes a positive coefficient in Model III ($p = .095$), implying that, as predicted, PE firms are more likely to buy divested businesses from firms who provide weaker long-term incentives to their divisional executives as compared to their corporate executives. In economic terms, divestments from parents whose long-term compensation for divisional executives is half that of comparable compensation of corporate executives are 13.4% more likely to be acquired by PE firms than those from parents where the two types of executives receive equal levels of long-term compensation. While the statistical significance of the coefficient for this measure is somewhat weak, a test of the improvement of fit from adding this variable to the regression strongly supports its inclusion (Prob[chi-square] of fit improvement = 0.012). We therefore interpret Model III as showing support for Hypothesis 4. Overall, the results in Table 2 are strongly consistent with our theoretical arguments, with Model III showing support for hypotheses 1, 2a, 3, and 4.

4.2 | Supplementary analyses

Having found support for our main theoretical predictions, we next undertake two sets of supplementary analyses to further explore our findings. First, we test our predictions for Hypotheses 2 through 4 in subsamples of core and noncore divestments. Noncore businesses may be especially susceptible to problems of myopia and weak divisional incentives (Feldman, 2016; Liebeskind, 2000; Markides, 1992, 1995), so that if our theoretical arguments are correct, we would expect the effects of our business-level predictions (i.e., hypotheses 2a, 2b, and 4) to be stronger for noncore divestments than for core divestments. Conversely, the effect of parent-level variables (Hypothesis 3) may be weaker for noncore businesses.

Models IV–VII in Table 4 show the results of this analysis, with Models IV and V showing the first- and second-stage regressions for the subsample of core businesses, respectively, and Models VI and VII showing them for noncore businesses. Comparing between Models V and VII we find continued support for Hypotheses 2a and 4 in the noncore divestment subsample ($p = .056$ and

¹⁴All economic significance calculations hold all other variables at their sample means.

.025, respectively), but no evidence of a significant effect in the core divestment subsample ($p = .292$ and $.202$, respectively). In addition, Model VII shows some support for Hypothesis 2b in the case of noncore divestments, with a positive coefficient ($p = .055$) of *Rival New Asset Durability Higher than Parent*, while we see no evidence of support in the case of core divestments in Model V ($p = .581$). In economic terms, noncore divestments where rivals' average new asset durability exceeds that of the parent firm are 55.8% more likely to be acquired by PE firms, compared to those whose rivals invest less in durable capital assets than their parents. At the same time, the effect of parent-level executive compensation is more pronounced in the core divestment subsample ($-0.804; p = .105$) than in the noncore divestment subsample ($-0.631, p = .136$). While these differences are not statistically significant, they are directionally consistent with our theory, and lend further support to our theoretical arguments.

Second, we examine the heterogeneity of corporate buyers. While our main findings treat corporate acquirers as a homogeneous category, corporate buyers differ along many dimensions (Halebian, Devers, McNamara, Carpenter, & Davison, 2009), and these differences may be reflected in distinct acquisition strategies. To explore this possibility, we break corporate buyers into various categories and use a multinomial logit to examine the likelihood of PE acquisition relative to these distinct types of buyers. For ease of presentation, we flip our dependent variable in this case, making PE acquisition the base category, so we can easily compare each acquirer type to PE firms independently. The results of this analysis are shown in Table 5, which begins by confirming that our results continue to hold when we switch from a probit to a simple logit¹⁵ model (Model VIII), dropping the endogeneity correction, and changing the base category.

We then begin by examining the distinction between corporate acquirers who are related or unrelated to the divested business (Model IX), in light of a long-standing literature that stresses the importance of relatedness between acquirer and target (Capron & Pistre, 2002; Kim & Finkelstein, 2009; Laamanen et al., 2014). The results in Model IX show that our main results are driven largely by differences between related corporate acquirers and PE buyers, with related buyers being significantly less likely to buy noncore businesses ($p = .002$), businesses with rival R&D intensity greater than parent ($p = .006$), or businesses whose parents have weak divisional incentives ($p = .099$), and significantly more likely to buy divestments from parents with strong long-term incentives for their top executives ($p = .1$). We see this as consistent with our argument for a separating equilibrium, with corporate buyers pursuing relatively well-managed businesses in related areas that they can integrate with their existing operations to realize synergies. In contrast, unrelated corporate acquirers generally pursue targets similar to those pursued by PE firms, consistent with the idea that such buyers are seeking to mimic the strategies of PE firms. In doing so, however, they seem to pay less attention to incentive issues, being more likely to buy targets from parents with strong long-term incentives than PE firms ($p = .049$), and somewhat less likely to buy targets with weak divisional incentives ($p = .105$). We see these results as being consistent with our claim that unrelated corporate acquirers are less well suited as a governance form to correcting problems of underinvestment than PE firms.

Model X builds on the evidence for the benefits of acquirer experience (Barkema & Schijven, 2008b; Halebian & Finkelstein, 1999; Zollo & Singh, 2004) by examining the differences between experienced and inexperienced acquirers.¹⁶ Our results show that PE firms are similar to experienced acquirers in their tendency to pursue noncore businesses and businesses subject to potential

¹⁵All of the other models in the supplementary analysis are estimated using *mlogit* command in Stata 13, with an otherwise similar specification to the main models, with robust standard errors clustered at the parent level.

¹⁶We define experienced acquirers as those in the top quintile of acquirer experience in the last 5 years.

underinvestment in R&D, consistent with the idea that PE firms may have stronger acquisition capabilities than most corporate acquirers. However, Model X also shows that experienced acquirers are more likely to pursue divestments from parents with strong incentives than PE firms ($p = .014$), and are also more likely to pursue divestments by high-performing parents (in terms of operating performance) than PE firms ($p = .081$). We believe this may reflect the superior ability of experienced corporate acquirers to realize value through capability acquisition (Kaul & Wu, 2016), which may prompt them to target relatively high-performing noncore businesses, even as PE firms pursue those that are noncore and struggling. Interestingly, while we see significant differences between PE firms and inexperienced acquirers in Model X, the differences between experienced and inexperienced acquirers are generally insignificant, suggesting that experienced buyers lie somewhere between inexperienced acquirers and PE firms in terms of their acquisition behavior.¹⁷

A third dimension to consider is whether the acquirer is publicly or privately owned, to account for the possibility that it may be simply the fact of private ownership, rather than the specific form of PE governance, that drives our results. To test for this possibility, Model XI compares PE acquisition to acquisition by public corporate and private corporate firms separately. We find no significant differences between the two types of corporate acquirers, however, with PE firms being significantly different in hypothesized ways from both types of acquirers. This is consistent with our argument that PE firms are a unique governance form. Finally, given prior literature on the uniqueness of cross-border acquisitions (Morosini, Shane, & Singh, 1998; Seth, Song, & Pettit, 2002), we separate foreign and domestic acquirers in Model XI. As in Model X, we see no significant differences between corporate acquirers in this case, with both types being different from PE acquirers in similar ways.

5 | CONCLUSION AND DISCUSSION

The findings of our study offer important new insights into the phenomenon of PE buyouts. Our results show that when buying divested businesses PE firms systematically prefer noncore businesses, businesses whose rivals invest more in R&D than the business's erstwhile parent (and who may therefore be underinvesting in R&D), and businesses whose parents have weak long-term incentives for their top executives, especially when these incentives are weaker for divisional executives than for corporate executives. These findings provide strong support for our theoretical argument that PE ownership is a distinct governance form that helps to overcome underinvestment problems resulting from the high coordination costs, weak incentives, and myopia associated with large public corporations.

By offering these insights, our study contributes to an improved understanding of the PE phenomenon. While prior strategy research has focused on the performance consequences of buyouts (Phan & Hill, 1995; Seth & Easterwood, 1993; Wiersema & Liebeskind, 1995), our study is among the first to focus on the antecedents of buyouts and the target choices of PE firms. Understanding which targets are more susceptible to buyout is important because it provides new insight into the way PE firms operate, and the characteristics they look for in a target. Moreover, by studying the antecedents of buyouts in the context of divestments we not only extend the literature on buyouts to look more closely at the widely prevalent but understudied phenomenon of divisional buyouts, we are also able to more directly observe the choices of PE firms relative to other corporate buyers in a context where they are in potential competition. In doing so, we offer a new theoretical account of

¹⁷We ran a similar analysis for less and more experienced PE firms and found no significant differences.

PE firms, one that reconciles the disciplinary and entrepreneurial perspectives in the prior literature (Jensen, 1986; Wright et al., 2000), and is backed by large-sample cross-industry empirical evidence. Our study suggests that rather than seeing PE firms as opportunistic raiders of corporate assets, stripping down corporations for short-term gain, we may more accurately think of them as investors in strategic resources and capabilities, allowing businesses to pursue valuable long-term opportunities that may have gone unpursued under public equity ownership.

This perspective in turn has important implications for the literature on corporate governance. We stress that the separation of ownership from control in the public corporation not only leads to the agency problem of aligning managerial incentives, it may also lead to underinvestment problems where *ex ante* alignment is incomplete or even maladaptive, as in the case of long-term strategic assets that are associated with high information asymmetry and uncertainty (Benner & Zenger, 2016; Edmans, 2009; Stiglitz, 2000). Our study thus joins a growing body of strategy research that highlights the negative consequences of equity market pressures (Zhang & Gimeno, 2010; Feldman & Montgomery, 2015), especially for novel or technologically sophisticated investments (Folta & Janney, 2004; He & Wang, 2009; Litov et al., 2012). In particular, it suggests that in situations where the coordination costs of hierarchy are too high (Williamson, 1985; Jones & Hill, 1988), PE buyouts may be a means to restore the business's independence and enable investments in long-term strategic assets. These investments in turn serve as the basis of value creation and capture for PE firms, with such firms exiting from the acquired businesses once the value of these investments has been realized, and the uncertainty around them has decreased, leaving the focal businesses ripe for public market ownership again. PE firms may thus represent a transitory governance form (Nickerson & Zenger, 2002), consistent with their playing an entrepreneurial role (Berg & Gottschalg, 2005; Wright et al., 2000; Zahra, 1995).

Our study also speaks to the literature on divestment (Berry, 2010; Brauer, 2006; Feldman & McGrath, 2016). While numerous studies have examined the antecedents and consequences of divestment, there is relatively little work examining who buys divested assets. Our study starts to address this gap, examining not only the role of PE firms, but also, in supplementary analyses, the differences between corporate buyers. In particular, it suggests a separating equilibrium between corporate acquirers and PE firms, with corporate acquirers being better off pursuing targets in related or complementary businesses, where they can create value by realizing operational synergies and recombining strategic capabilities (Capron & Pistre, 2002; Laamanen et al., 2014), while PE firms pursue businesses suffering from underinvestment in order to realize value through improved governance. Thus, while corporate buyers create value by enabling beneficial coordination and co-specialization between themselves and the acquired business, PE firms create value by reducing harmful coordination between the acquired business and its erstwhile parent.

As with any study, our work has its limitations. Most notably, because we are unable to track what happens to businesses after they are acquired, we do not know what changes, if any, the PE firm (or the corporate acquirer) implemented in the target's governance, nor are we able to study the success of these firms in creating value from buyouts. Data limitations also mean that we are unable to study the incentives and performance of divisional managers directly; while we try to examine underinvestment and weak incentives at the divisional level, our measures are admittedly crude, and though this does not negate our findings, it would be useful to have them validated with more precise and fine-grained measures. Our study is also limited in that we do not explore the heterogeneity of PE firms (Castellaneta & Gottschalg, 2016; Hoskisson et al., 2013), treating them as a single class of buyer.

These limitations notwithstanding, we believe our study represents an important initial step toward a better understanding of the PE phenomenon in the strategy literature, and hope that it may serve as a foundation for further exploration of this important topic. Future work could explore target selection in buyouts of stand-alone firms, or examine the subsequent exit strategies of these buyouts. Future work could also use our empirical findings to better account for the endogeneity of buyouts when assessing their performance consequences (Smart & Waldfogel, 1994), as well as to examine the consequences of divisional buyouts for the corporate parents.

To conclude, we examine the antecedents of PE buyouts by investigating the types of targets that are most likely to be bought by PE firms from among the businesses divested by large public corporations. We show that PE firms are systematically more likely to buy divested businesses that lie outside the corporate parent's core area, and those that may be subject to myopia and weak long-term incentives. We interpret these findings as supporting the theoretical argument that PE firms constitute an alternate governance form, one highly effective in addressing problems of underinvestment in public corporations through vigilant monitoring, stronger incentives, patient capital, and an ability to restore business independence. Our study thus contributes to the strategy literature by providing fresh insight into the important but understudied phenomenon of nonventure private equity.

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