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LONGEVITY AND THE LIFE-CYCLE OF MANAGEMENT BUY-OUTS

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The longevity debate about buy-outs has hitherto been restricted. By focusing on large highly leveraged transactions, existing research has taken only a partial view of how long buy-outs last and the factors influencing longevity. This paper develops and tests hypotheses concerning the influences on buy-out longevity across the whole spectrum of management buy-out applications. Both quantitative and case study evidence from the U.K. is presented. A heterogeneity view of buy-outs is supported. Tests using quantitative data show that earlier exit is associated with larger buy-outs, and buy-outs arising on privatization from the public sector and from non-U.K. parents. Case study evidence principally supports hypotheses that earlier exit is associated with financing institutions being in a relatively stronger position than management and with more rapidly changing market conditions for the firm.

INTRODUCTION

Over the past decade or so, the buy-out has become a significant organizational form, both in the U.S. and U.K. The U.S. market has been characterized by management and leveraged buy-outs of stock market quoted corporations (Jensen, 1989), although there is also a high level of activity involving the voluntary divestiture of divisions and of privately-held firms. In the U.K. voluntary divestiture of divisions and subsidiaries to management-dominated companies remains the principal source of buy-outs, followed by management and manager-employee buy-outs of business enterprises divested from state-owned firms, failing public companies, or privately held firms (Wright, Thompson and Robbie, 1991). Arguments have been developed that the financial and ownership characteristics of buy-outs offer incentives and governance structures, involving new ownership patterns and different forms of board representation, which give the form an advantage over the quoted public corporation and the available empirical evidence broadly confirms that operating performance does typically improve in the post buy-out period (see e.g., Palepu, 1990, for a review; Singh, 1990; Seth and Easterwood, 1993). What is not resolved, however, is the question of the longevity of the buy-out form. The comparative advantage generated by high incentives and a new governance mode might be expected to lead to the buy-out - perhaps reinvigorated by periodic injections of new debt - replacing the quoted corporation, as argued by Jensen (1989). However, counter-arguments have been put forward to suggest that the buy-out form's comparative advantage is more transient. Rappaport (1990), for example, considers that it lacks the flexibility of a firm financed by traded equity and that the buy-out principally represents an opportunity to make performance-enhancing changes and that once

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these have been enacted the company will simply return to its former growth path, albeit at an improved position. In this paper we argue that the longevity debate has hitherto been restricted since, by focusing on large highly leveraged transactions, it takes only a partial view of buy-outs and hence of how long they last. We examine conceptual issues and using quantitative data and case studies, provide preliminary tests of hypotheses concerning the influences on buy-out longevity across the whole spectrum of buy-out applications.

The paper first provides definitions of buy-outs which is followed by an outline of the key governance issues they raise. The study then moves on to examine the factors influencing the life-cycle and longevity of buy-outs. The empirical part of the paper begins with an outline of the data sources and research methodology used. The first section dealing with empirical results presents evidence from the authors' monitoring of the U.K. buy-out market concerning the extent and nature of buy-out changes in ownership structure. Much of the evidence on buy-outs is quantitative. This ignores the uniqueness of many such transactions and leads to either/or conclusions concerning, particularly, longevity. The second empirical section examines qualitative evidence in the form of an analysis of three case studies in the U.K., which illustrate the *varying* influences of ownership form and motivation, financial structure and market factors on the longevity and form of subsequent ownership in buyouts. The final section summarizes the main findings of the paper and suggests areas for future systematic analysis of the longevity of buy-outs.

BUY-OUT DEFINITIONS

In this paper the term buy-out is used in a generic sense to cover a variety of related organizational types. We contend that the core characteristics are: first, the full or partial transfer of a firm's assets, embodied in operational business units, to a new company established for the purpose of running them; second, a comparatively high reliance on debt—of one form or another—in the financial structure of the new company; allowing thirdly, the relative concentration of equity ownership, with managers and some participating institutions typically holding substantial voting blocks.

The above definition embraces deals ranging from very large leveraged buy-outs to transactions in which quite small businesses are sold to companies formed by groups of managers. In the former case publicly quoted corporations are taken private with the deal price being met from the proceeds of assorted debt issues, together with some equity subscribed by an initiating LBO Association and a group of investors coordinated by the Association. The absolute size of the transaction will normally preclude managers taking more than a very small share of the voting equity. By contrast, Malone (1989) has described the smaller management-led U.S. deals. These typically involve the purchase of a divested division with venture capitalist backing and much lower levels of leverage.

In the U.K., deals are more obviously *management* buy-outs and the evidence presented in subsequent sections focuses on this part of the overall market. A substantial majority of cases are completed for prices below the equivalent of $20 million, with approximately two-thirds of the transactions resulting from divisional divestitures (Chiplin, Wright and Robbie, 1991). In a typical case, a group of four to six incumbent managers will initiate the deal and obtain a majority of the equity, with funding from venture capitalists, debt financiers and banks. Of course, the extent of participation across the managerial team varies substantially between management buy-outs. In some cases this is limited to a small number of senior executives. In others, lower tier managers are encouraged to participate: for example, in retailing chains store managers may be encouraged to invest. Finally, equity ownership may extend beyond the managerial ranks to embrace production workers. In the U.K., privatization buy-outs have frequently included worker involvement, not least to defuse union hostility. In both the U.S. (Singh, 1990—Appendix A) and U.K., size exerts a considerable effort on the financial and governance structures. As in the U.S., U.K. data Chiplin *et al.* (1991) suggest that smaller buy-outs are likely to use lower debt-equity ratios than larger ones. Similarly, smaller buy-outs appear less likely to involve boardroom representation from financial institutions.

INCENTIVE AND GOVERNANCE ISSUES IN BUY-OUTS

The analysis of Jensen (1986, 1989), a focus for the debate in this area, presents buy-outs as devices to reduce the agency costs of exercising control over corporate assets. The agency problem exists in the typical divorce of beneficial ownership from effective control in firms with a diffuse set of shareholder-principals. The diluted or even nonexistent equity interest of managers may bring departures from profit-maximizing behavior to the detriment of shareholders (Fama and Jensen, 1983). Jensen (1989) argues that these problems have been exacerbated by the decline, particularly in the U.S., of active investors who take a role in monitoring public companies. The result has been to leave managers with considerable freedom to divert resources to preferred uses, particularly into unprofitable diversifying acquisitions by firms with strong 'free' cash flows, i.e., with restricted investment opportunities in their core businesses.

Buy-outs have been analyzed as devices to reduce agency costs by the introduction of greater management incentives and tighter governance structures. Managerial rewards are more closely aligned to firm performance, through devices such as significant direct equity ownership, stock options and in the U.K. at least, 'equity ratchets' by which the management team's proportion of the voting equity may be increased conditional upon medium term performance targets and which may decline if such targets are not met to give the financing institutions greater control. Management equity stakes typically represent a substantial part of their personal wealth and as such a sunk commitment which may be lost if the firm fails to meet its debt obligations and is put into bankruptcy. This in theory restricts participation in a buy-out to those with a strong motivation to succeed. If management fails to perform, equity ratchets may give control to financing institutions who may initiate the acquisition of the company by a third party and so facilitate their own exit. In standard agency models monitoring is strictly a vertical activity. However, another aspect of increased equity participation within the firm is that horizontal monitoring is encouraged. This is most obvious among members of the management team in a buy-out. In the event of wider employee involvement such actions might be expected elsewhere within the firm.

The financial structure in buy-outs also tightens governance arrangements so as to reduce managerial discretion. The existence of large blocks of debt and the desire of debt arrangers to protect their reputations means that there are strong incentives for lending institutions as well as equity investors, often through the lead institution where finance is syndicated, to seek close monitoring of the buy-out organization. Thompson and Wright (1991) show the extent of institutional involvement in providing non-executive directors, chairpersons, and fuller and more frequent information flows than would ordinarily be provided to outside equity investors together with other controls such as close scrutiny of capital expenditure plans and executive remuneration.

Buy-outs consequently involve an integrated governance system, comprising managerial equity incentives which may be enhanced by the use of financing instruments to increase or decrease management's equity stake according to how well performance targets are met, the commitment to meeting the costs of servicing high levels of dept and other debt-like instruments, and close involvement by institutional investors who have an incentive to be active monitors through board representation and more detailed and regular financial reports than may be expected by outside investors. These financing instruments, motivational aspects and control arrangements in buy-outs thus provide a range of both mechanistic and flexible means of funding and controlling buy-outs in different situations and processes by which adaptation to changing circumstances can occur (Jones, 1992; Wright, Thompson and Robbie, 1992; Green and Berry, 1991; Sahlman, 1990).

The above arguments suggest a strong affirmative case for the buy-out form as a means of increasing incentives and introducing more effective corporate governance, and a growing body of empirical evidence gives general support to the case (see Palepu, 1990 for a review of U.S. evidence and Wright, *et al.,* 1991 for U.K. and other evidence) However, to conclude from this that the buy-out form represents a superior long term alternative to the quoted corporation may be to over-state its claims. The next section examines influences on the longevity of buy-outs.

INFLUENCES ON THE LONGEVITY OF BUY-OUTS

Rappaport (1990) regards buy-outs as merely transitory organizational forms because of their innate limitations—poor strategic flexibility imposed by high debt levels, desire of investors to cash out, the absence of a daily stock price as an objective measure of corporate value and restricted market applicability. As Kaplan (1991) notes, the Rappaport view is consistent with buy-outs as 'shock therapy', whereby managers are incentivized to undertake one-off restructuring after which the benefits of buy-out incentives are necessarily smaller and buy-outs at some relatively near future point need to change their ownership form once again. We would argue that both Jensen and Rappaport unduly restrict the conditions under which buy-outs occur and fail to explain the widespread existence of buy-outs in circumstances which do not fit the strict Jensen criteria (see Chiplin, *et al.*, 1991 for a review) either in terms of sectors, and the variety of control mechanisms and financing structures outlined above. Given this market diversity, a range of influences on longevity may be expected. This section analyzes such influences conceptually, providing the basis for empirical testing in later sections. In general there is at present little direct and systematic attention to the factors which may influence the longevity of buy-outs. Examination of the buy-out process suggests that for each individual transaction the interests of the three parties involved so that a buy-out can be completed - management, institutions and the company itself (Wright, *et al.*, 1991, ch.7) - influence the longevity of the buy-out form.

The influence of managers is particularly important given the evidence that the initiative for a buy-out is normally taken by management who perceive an entrepreneurial opportunity (Bull, 1989; Wright, Thompson and Robbie, 1992) and that, especially in smaller buy-outs, management have majority or even super-majority equity stakes. The use of ratchet mechanisms, as noted earlier, is a means by which, subject to achieving predetermined targets, management can increase their stake. Where management have highly specific nontransferable skills they may have little option but to remain with the firm into the long term and evidence from buy-outs suggests widespread long term commitment to the firm (Wright and Coyne, 1985). By the same token, outside purchasers may be dissuaded from acquiring such a company where incumbent managers are reluctant to accept them. The extent to which managers may wish to continue to pursue an entrepreneurial career rather than exiting through a sale to a third party and becoming managerial employees again or retiring also impacts on longevity. Differences in the motivations of buy-out managers (e.g., reacting to a one-off opportunity vs. proactive recognition of a chance to implement one's own growth strategy (Wright *et al.*, 1992: 60) may also influence the longevity of a buy-out. Employee ownership can be an important factor in buy-out longevity since employees owning shares in the company where they work are likely to have an undiversified portfolio of assets, producing a medium to long-term desire on the part of management and employees to sell some or all of their shares and reinvest the proceeds in a more diversified portfolio. With a workforce which is relatively stable in size and with little staff turnover, there is also a possibility that the internal share market of an employee buy-out would soon run out of sufficient liquidity to operate effectively (Ben-Ner, 1988).

Buy-out markets typically involve a variety of institutional participants, ranging from local clearing banks, through various venture capitalists, to large specialist debt and equity providing closed-end funds (Wright *et al.*, 1992). Requirements for institutions to provide returns based on capital gains to shareholders in the short term (within a 3–5 year period) will clearly influence the type of buy-out in which they will invest and the speed of exit they seek. Equity ratchets which are triggered on exit and/or close and flexible control may be used to help ensure that exit is achieved in a time-scale that meets the institution's objectives, especially where management does not have majority equity stakes. Differences may be expected in the approach of institutions who do not operate under this constraint, but who may be motivated more by obtaining a longer-term dividend stream, with consequently differing perspectives on the timing of exit.

These points suggest the following two propositions.

Proposition 1: Differences in comparative *equity holdings and leverage rates will result in significant differences in exits from buy-out being sought. Larger buy-outs and those where management have significant ratchet incentives will have a higher propensity to achieve some form of realization. The majority of smaller buy-outs, where management have majority equity ownership, are likely to remain independent for longer periods.*

Proposition 2: The greater the desire for risk spreading by incumbent employee share owners and the more illiquid is any internal share market, the earlier is exit likely to be.

Life-cycle theories suggest that the most important company-related characteristics which are likely to influence the longevity of a given organizational form concern rapidly changing markets, a fast growing company, concentrating markets where it is necessary to have sufficiently large critical mass to survive, and relatively high levels of merger activity (see e.g., Mueller, 1988 for a review of the literature). Although the classic Jensen buy-out is in a stable industry, unforeseen events may occur to change its life-cycle and financing instruments are available to enable buy-outs to occur in less stable and predictable circumstances (Wright *et al.*, 1991). The resource-based perspective of the firm (see e.g., Mahoney and Pandian, 1992 for a review) contends that a firm's competitive advantage depends upon the exploitation of its specific assets, which may be physical, locational, human, reputational, or organizational in character. Where a firm has an underutilized resource it may generate value if this resource is divested to an owner who will make better use of it.

Buy-outs, and particularly management buy-outs, have also been part of a restructuring trend based on the redefinition of firms' activities and which in particular has encouraged the deconglomeration of multiproduct firms. Selling divisions to managers allows the parent and the former divisional managers to focus on the exploitation of specific assets in separate entities. Divestment buy-outs or those arising on privatization from the public sector may have experienced severe pre-buy-out constraints on investment policies, new product development, internal control mechanisms, etc. frequently imposed by private sector parents (Jones, 1992; Wright *et al.*, 1991). Such firms may grow rapidly initially when such constraints are released. However, there is no reason why the buy-out arrangement should be permanent. The potential for expansion offered by the new configuration may require a reversion to a quoted company form if the best use is to continue to be made of the assets. Buy-outs may come up against new constraints and require to exit to continue to survive or develop (Green and Berry, 1991). Financing structures may attempt to allow for future growth but considerable uncertainty and underestimation of its extent may pose problems. The extent to which finance servicing costs and investment needs can be met from internal generation of funds will thus also influence longevity. In addition, where a division has been constrained and has lost ground in a rapidly growing market it may be difficult to catch-up indicating that exit to become part of a larger group is warranted. Buy-outs from privately owned or family firms may be expected not to have experienced such problems pre-buy-out.

Thus two further propositions are suggested:

Proposition 3: Where buy-outs require significant sums for capital expenditure programs beyond the levels initially envisaged in the buy-out, or there are significant structural changes in the market, the probability of exit will be higher.

Proposition 4: The greater the extent of pre-buy-out constraints on development, such as access to investment funds and ability to exploit new markets, and the greater the problems in catching-up in rapidly changing markets, the greater is the pressure for early exit likely to be.

The above propositions center on three clusters of company-specific influences on longevity: management factors, ownership and financial factors; and competitive and other market factors. In the rest of the paper we use both quantitative and qualitative methods to shed light on the above propositions. Given that the principle aim of this paper is to draw attention to the need to consider longevity across the wider spectrum of buy-outs, the empirical evidence is intended to provide more illustrative insights into the above propositions rather than to present definitive conclusions. As is emphasised in the conclusions, further research may be directed at testing more systematically the aspects of longevity identified here.

DATA AND METHODOLOGY

The data presented in this paper are drawn from the authors' data base of the U.K. population of management and employee buy-outs. The data base contains, as far as it is possible to do so, the total population of buy-outs in the U.K. (more than 5,000 buy-outs). It is continuously updated in terms of adding new buy-outs and with respect to tracking exits using several sources: a six monthly survey of all known financing institutions and the major accounting participants in the U.K. buy-out market using a standardized research instrument to collect transaction details supplemented by other more detailed questionnaire surveys;[1] a systematic search of on-line text data bases and financial news services; a systematic search of annual reports of major firms; monitoring of the *London Gazette*; and a search of other specialist financial press. The analysis of exits which follows utilizes all buy-outs on the data base for the period 1981–1990 where the original transaction value is known.

To examine our propositions and also to facilitate the further generation of theory, three cases were selected from the overall population on a judgmental basis to reflect the broad scope of issues raised by longevity, particularly those buy-outs which had exited and those whose structure had remained unchanged for in excess of 7 years. Management led employee buy-outs were included in the analysis both because, as noted earlier, they raise particular issues relating to agency costs, and because they introduce important aspects which may influence the longevity of the buy-out structure.

Data for the cases were collected both by personal interview and by desk research by the authors. The interviews were conducted with senior members of buy-out teams and lasted between 2- and 3 hours. These covered issues concerning all aspects of the buy-out, including the exit-related subset reported here, based on completion of a standard questionnaire to obtain data relating to the transaction and afterwards and a flexible semistructured checklist to obtain more detailed information concerning the processes involved in the buy-out. The face-to-face interviews were supplemented by detailed desk research conducted by the authors both prior and subsequent to the interviews. The material included press articles on the cases, information supplied by the financing institutions, and direct inspection of institutions' investment reports and the companies' statutory returns to U.K. Companies House.

THE LONGEVITY OF BUY-OUTS: QUANTITATIVE EVIDENCE

Through the quantitative data available it is possible to find some support for Propositions 1 and 4. Evidence collected by the authors from their regular monitoring of buy-outs in the U.K., as detailed above, shows that up to the end of December 1992, 21.4 percent (433 out of 2,023) of buy-outs completed between 1981 and 1990, where the value of the transaction was known, had exited by either flotation, sale to a third party or secondary buy-out/buy-in (Table 1). Proposition 1 suggested that different exit rates might be expected between buy-outs of different sizes. This is supported by the evidence in Table 1. To the end of December 1992, significant differences are found in the rate of exit between buy-outs with transaction values above and below the median value for each year in the period 1981–1989. In each year, larger buy-outs are significantly more likely to exit.

Proposition 4 suggests that the extent of pre-buy-out constraints on development will be associated with earlier exit. The authors' monitoring of the different sources of buy-out in the U.K. shows that buy-outs of public sector activities, arguably the ones to experience the greatest pre-buy-out constraints and difficulties in catching-up in rapidly changing markets have, on the basis of z-tests, a significantly higher propensity to exit (Table 2), a finding also supported by a more specific study of exit timing of buy-outs in the privatized bus industry (Thompson, Wright, and Robbie, 1990). Buy-outs which had originated on divestment by non-

[1] Copies of the research instruments used are available on request from the authors.

Table 1. Exits of large and small buy-outs completed between 1981 and 1990 at end December 1992

Year of MBO	Median transaction value in year (£m)	Exit by flotation, trade sale, secondary MBO/MBI: Less than or equal to median value		Greater than median value		
		No. exiting	% of all MBOs in category	No. exiting	% of all MBOs in category	Chi-squared[1]
1981	0.62	7	21.2	21	65.6	11.3*
1982	0.50	11	17.5	29	50.9	13.6*
1983	0.52	11	18.3	28	46.7	9.7*
1984	0.70	18	26.4	41	69.5	13.2*
1985	0.50	17	16.8	49	49.0	22.1*
1986	1.00	14	11.8	51	45.1	30.4*
1987	1.40	21	17.2	46	38.7	12.8*
1988	1.78	12	9.3	25	19.4	4.5**
1989	2.00	4	2.7	14	9.5	5.1**
1990	1.30	4	2.3	10	5.8	2.0
All Years	1.07	137	13.5	296	29.4	74.4[2]

[1]Significance levels: * 1% level; ** 5% level; total sample was 2,023
[2]Using a 'large-small' split at transaction values above and below $20m (the cut-off point conventionally used by the U.K. financial community) also yields a significant difference in exit rates for the period.

Table 2. Exit by source for buy-outs completed between 1981 and 1990

Source	Number exiting +	Total buy-outs	Exit/ total %
Divestment (U.K. parent)	216	1100	19.6
Divestment (overseas parent)	74	198	37.3
Private/family	72	426	16.9
Privatization	33	83	39.8
Receivership	16	97	16.5
Going Private	6	30	20.0
Source not specified	16	89	18.0
Total	433	2023	21.4
z-tests:			
Total vs. Divestment (overseas)			z = 5.10*
Total vs. Privatization:			z = 3.40*
Total vs. Receivership:			z = 1.15
Total vs. Private:			z = 2.09**
Total vs. Going Private:			z = 0.17
Total vs. Divestment (UK parent)			z = 1.25
Total vs. nonspecified			z = 0.81
Chi-Square: sources vs. exit			= 55.9, p = 0.000

*Significant at 1% level; **Significant at 5% level.
+ By means of flotation, trade sale or secondary buy-out/buy-in.
Source: CMBOR/BDCL/Touche Ross

U.K. parents also demonstrated significantly higher exit rates. In contrast, buy-outs of private/family firms have a significantly lower propensity to exit, perhaps reflecting the lower constraints experienced by such firms prior to buy-out. Of the six going private buy-outs to have exited only two have returned to the stock market.

Propositions 2 and 3 are more amenable to examination through case studies to which we now turn.

CASE STUDIES

The cases of buy-outs analyzed in this section seek to shed further light on the propositions outlined above and to suggest further research areas concerning the links between initial ownership and control structures, contingent factors and trajectories of development. As noted above the information has been gathered from a mixture of personal interviews with senior management over the past decade and desk research. The first, that of TIP Europe, illustrates the influences on early exit in a highly geared buy-out. The second, Mansfield Shoe, was a management led employee buy-out of a shoe manufacturer in receivership completed in the early 1980s which now, although it remains independent, has a very small element of employee ownership. The third case, National Freight, concerns an employee buy-out in the transport sector which arose on privatization and which after 7 years floated on the stock market.

TIP Europe—A management buy-out with subsequent flotation on the London and Amsterdam Stock Markets

TIP Europe illustrates factors that can lead to the short-lived nature of a buy-out and sheds light on Propositions 1 and 3. Specifically, the case shows that management obtained a minority equity stake and although institutions envisaged exit through flotation in a reasonable amount of time (Proposition 1), this was brought forward as a result of pressures from enhanced growth opportunities and increased market competition and merger activity (Proposition 3). Although management were able to reverse many of the constraints imposed by the former parent, there is also some indication that 'catching-up' was also a contributory factor to early exit (Proposition 4).

At the time of the buy-out TIP Europe plc was the European market leader in trailer rental. The company was a subsidiary of the U.S. corporation Gelco and was divested through a buy-out in 1986. Flotation was achieved in 1988 and was followed by a series of acquisitions. The U.S. parent first established a European presence in the late 1960s and by the mid 1980s was Europe's largest trailer rental organization with a market share of 23.7 percent. Apart from two other major competitors, the rest of the market was highly fragmented. The company had joint headquarters based in the U.K. and Holland. The industry and TIP expanded in the second half of the 1980s. Such expansion required a heavy capital commitment and associated borrowings. In mid-1985 the management of TIP Europe became aware that the parent was not able to finance its future plans because of severe corporate financial troubles. TIP Europe was not receiving adequate support from the parent for product development and market expansion programs which threatened long term performance. In August 1985, the parent officially announced that as part of its restructuring plan it intended to divest TIP in order to repay large debts and to concentrate on core business areas in the U.S.

TIP top management initiated a management buy-out. A purchase price of U.S. $59 million (£40.7 million) was agreed, representing a multiple of 4.7 on profit before tax and with net assets of £29.3 million. The need to allow for the commitment to significant capital expenditure resulted in a debt:equity ratio of slightly over 2:1. Management invested £500,000 for an initial stake of 10 percent. The three top managers purchased 51 percent of this stake, extending participation for the balance to 19 key managers according to seniority as it was felt they were individually important in this kind of business in influencing turnover. In addition there was a management ratchet allowing their equity to increase to 15 percent on achievement of certain profit targets with a further 2 percent available for overachieving. The equity was syndicated to 14 institutions and debt was syndicated to both U.K. and Continental European banks.

Following the buy-out important changes were made to the financial and organizational aspects of the company to reinforce a structure which encouraged an entrepreneurial and sales orientated approach at branches but within the framework of strong and centralized control systems especially cash management, cost control and tax planning. Significant improvements were reported in the quality of communication between the financial head office based in Holland and the branches. Considerable attention was also paid during the first year of the buy-out towards business expansion through for example upgrading and expanding the trailer fleet. Several major policy decisions which had been imposed by Gelco on TIP were reversed. These policy changes and the increased motivation arising from the buy-out brought a significant improvement in performance in the first year of buy-out; turnover in the year to end-July 1987 increased by 12.5 percent to £29.5 million and profit (before buy-out interest and taxation) by 71.4 percent to £8.785 million.

The original deal envisaged an exit through a flotation in a reasonable period of time. The very favorable stock market conditions of the summer of 1987 encouraged management and the institutional advisers to seek an earlier float than originally anticipated, although because of the stock market crash in October 1987 the float was delayed to February 1988. The float involved separate quotations in London and Amsterdam with the company being valued at £83.1 million compared with an expected valuation of around £100 million in October 1987. As part of the efforts being made to improve management and employee incentives, an employee share option scheme was introduced at the float. Existing management sold 678,000 shares while institutions did not sell any shares, partly because of more difficult stock market conditions. The balance of shares placed raised £15.25 million net after expenses for the company. This was to be used to reduce the buy-out debt and also to set the basis for further expenditure on the trailer fleet. At the same time major new bank facilities were negotiated to take account of the improved credit standing of the company post flotation. At the time of float TIP's management felt that the additional financial resources now available to the company would help it to sustain its leading position in the U.K. and Dutch markets and to expand elsewhere in Europe through organic growth and acquisitions; upgrade further the trailer fleet; and to enhance its strong and centralized reporting and control systems. In the immediate aftermath of flotation, considerable progress was made towards these targets, but continuing market changes and recessionary conditions led to further financial and managerial restructuring. In April 1993, the company was the subject of a takeover bid.

In summary, this case has shown that the main reasons for TIP's speedy flotation and hence the 'nonlongevity' of the buy-out can be summarized as follows: a sector marked by rapid restructuring and merger activity; low managerial equity stake with institutional influence for early exit; the need for extra finance to take advantage of growth opportunities and maintain competitive position, to some extent exacerbated by the pre-buy-out constraints imposed by the parent which raised catching-up difficulties. This case suggests some support for Propositions 1, 3 and 4.

Mansfield Shoe—A buy-out from receivership still independently owned after a decade

The Mansfield Shoe buy-out arose on the failure of its parent company and shows how a buy-out may remain independent for a considerable period. The case illustrates that the key factors in this regard were the role of super-majority managerial equity stakes and corresponding low pressure from financiers (Proposition 1), relatively stable market conditions and growth which could be funded internally (Proposition 3) and the buying back of employee shares which reduced pressure from employees for exit (Proposition 2).

Mansfield Shoe was formed at the turn of the century, supplying ladies' sandals, shoes and boots for the middle price range of the market. During the 1930s it was acquired by Norvic Securities and remained a wholly owned subsidiary until the time of the buy-out. Throughout its period as a subsidiary a separate identity was maintained with control and all management functions, except finance, left with Mansfield Shoe. The company was reasonably successful in adapting to market changes until the late 1970s when it became clear that managerial weaknesses were contributing significantly to poor performance. In 1980 a new managing director was appointed and major restructuring, new product development, quality enhancement and control system improvement began. The results of this action were that by mid 1981 and just prior to the buy-out, the company was once more making profits. However, in 1981, the parent company entered receivership, the final outcome of a decade of mistaken diversification and an inability to deal with major difficulties in the shoe market (Wright and Coyne, 1985). At the time of the buy-out in 1981, there were four members of the management team, covering the areas of managing director, sales, production and design. The finance director joined shortly after the buy-out, the finance function having previously been dealt with by the head office of the parent.

In total, eighty out of 330 employees purchased ordinary shares amounting to some 24 percent of the total equity. The request to employees to pledge redundancy money was made on the understanding that to do so did not guarantee a job. The remaining shares were held by the buy-out team with the managing director having the largest stake, a venture capitalist, and a pension fund. The balance of the purchase price was in the form of a loan (£202,000) and an overdraft (£75,000).

In the immediate aftermath of the buy-out, Mansfield Shoe experienced substantial improvements in performance associated with further cost rationalization consequent upon the buy-out. This improvement was such as to enable the venture capitalist's shares to be repurchased in 1983. This action had the benefits of increasing management control and of removing potential cash flow problems from servicing costs which would otherwise have had to be borne. Growth was achieved through increasing shoe production and through acquisitions. In 1983 a second shoe factory was acquired and in 1984 a further company was purchased. Both acquisitions were of companies which had entered receivership and which soon became positive cash flow generators. Wide discussion and communication was sought, including an employee–shareholder director, who was appointed by the employees and had full director's powers. In the short term, the existence of employee shareholdings was clearly perceived as having a positive general effect on motivation towards the success of the company.

By 1991, a decade after the buy-out and following share repurchasing the number of employee shareholders had fallen to eight who held a total of 7.3 percent of the share capital. The team of directors held 61.6 percent of the shares between them, with the balance of 31.1 percent held by the pension fund. Management now considered that whilst employee share ownership was necessary to gain commitment to the buy-out initially there was no continuing need for it now. The comprehensive profit bonus scheme is seen to be more appropriate as an incentive and reward than share ownership in the current stage of the company's development. The proportion of earnings available from the scheme varies substantially between different groups of managers and employees with the directors receiving a higher percentage than other senior managers.

A decade after the buy-out, three principal strategic issues need to be resolved. The first concerns the need to manage succession. Two of the original buy-out team have already retired, which provided an opportunity to strengthen the senior management team. The main concern is the successor to the managing director, the largest single shareholder, who retires in approximately 3 years, if the company is to maintain its aim of staying independent. The second issue, which is linked to the first, concerns the need to develop, through recruitment and training, a layer of middle management. Difficulties in recruiting such staff in the locality are particularly recognized. The third issue concerns ensuring continued growth. After the buy-out, manufacturing profits increased each year up to 1988/89, when there was a fall of 20 per cent. This decline was due in most part to problems within the shoe industry generally, with Mansfield Shoe maintaining its position at well above its main competitors and the average for the industry. However, such difficulties brought into focus the modest growth in volume in the previous five years and the absence of further productive capacity in the existing old-established premises. The company's response to these issues has been to instigate an active search for acquisitions in footwear manufacture, and a passive search for acquisitions in areas which support manufacturing.

To summarize, the main reasons for the longevity of the Mansfield buy-out were: super-majority ownership and control by management and consequently less investor pressure to exit; initial growth opportunities could be financed internally; relatively low level of merger activity in the industry; no imperative to merger to attain critical mass; buying in of employee shares hence avoiding the problem of need to exit to provide market liquidity; and the absence of need to exit to resolve conflicting managerial objectives since management's career expectations could be satisfied within the available opportunities presented by the buy-out structure. This case provides some support for Propositions 1 and 3. The reduction in wider employee share ownership contributed to a removal of pressures for early exit as suggested by Proposition 2.

National Freight—A management-led employee buy-out on privatization which floated after 7 years

The management-led employee buy-out of National Freight was completed in 1982 and illustrates the development of a successful organization which needed to take action to maintain both growth and the benefits of employee ownership in the longer term. The case, which involves longevity intermediate between cases 1 and 2, illustrates how a buy-out may exist as such for a relatively long period, but then need to exit. Specifically, the case shows how employee shareholder pressures for exit, were initially catered for by an internal share market, but this eventually became saturated (Proposition 2) and that while growth opportunities could be funded internally for 7 years, further possibilities brought pressure to exit (Propositions 3 and 4).

National Freight Corporation (NFC) was a state owned corporation from 1947 to 1982, experiencing significant losses for much of the later part of this period as it failed to adapt to a highly competitive market. After considerable debate as to how NFC might be privatized, the importance of management and employees in the running of the business was recognized in an agreement to sell the firm intact as an employee buy-out. The key role of employees located in over 700 depots and the generally anti-privatization stance of the firm's nine trade unions in NFC strongly influenced a requirement by potential providers of equity finance for widespread employee commitment through share-holding in addition to that of the senior management team which had originally proposed the idea of a buy-out. The institutions financing the buy-out were prepared to take a longer term view of their investment from the outset. The total purchase price of £53.5 million, represented a considerable discount on the book value of net assets which stood at £93.3 million. The 37.5 percent of employees who initially bought shares held 82.5 percent of the equity. Shares could be traded on an internal share market four times a year. Performance improvements and increases in the value of shares produced a substantial demand for shares from those depots which had previously heeded union advice not to buy shares.

Post buy-out performance improvements in NFC have been addressed in several studies (e.g., Wright and Coyne, 1985; Bradley and Nejad, 1989). Profitability increased consistently after the buy-out up to 1990 due to several factors: employee ownership and participation as such; the general economic recovery of the mid-1980s onwards; the positive effect of privatization on the willingness of some customers to use NFC to deliver their products; a new found flexibility that enabled management to switch the focus of activities from loss-making parcels operations to growth sectors include overseas activities; the introduction of specialist added value services which could not have been managed prior to privatization; improved management methods and organizational rationalization the benefits from the long process of restructuring that had occurred prior to privatization; and the disposal of large amounts of under-used property. It seems clear that incumbents appreciated the latent profitability of under-utilized depot sites in the center of many British cities indicating that NFC's assets were severely underpriced. After a period of continued growth, the year ending October 1991, produced a 4 percent fall in pretax profits.

After considerable internal debate about the merits of flotation, NFC became listed on the official market in London in 1989, with a market capitalization of £890 million. By the time of the flotation, average employee shareholdings of £600 in 1982 were worth £60,000. The proportion of employees with shares rose from 37.5 percent in 1982 to 80 percent upon flotation in 1989 and 90 percent in 1991. The main reasons for the flotation were twofold. First, there was a need to provide access to further capital to finance future expansion. Second, there was a need to augment the internal share market. With a workforce which is relatively stable in size and with little staff turnover, there was a danger that the internal market would soon run out of sufficient liquidity to operate effectively. Subsequent to the flotation, the extent of employee shareholdings fell to below 50 percent.

The NFC experience, contrasts with another management-led employee buy-out, that of Roadchef, an independent operator of motorway and trunk road service areas (Wright and Robbie, 1992). Roadchef, which was bought out in 1983, remains as an independent company and is similar to NFC in that continued wider employee ownership is an important factor in enabling management to incentivize and motivate employees. However, in Roadchef sustainable longevity of the buy-out is closely associated with the company's stable service oriented business which did not have the same kind of growth opportunities and financing needs as NFC.

In sum, the NFC case shows that the main reasons for the relatively long period of buy-out status before float were: employee shareholdings being important for motivation; growth opportunities which could initially be financed internally and from asset sales; both of which eventually began to run out, leading to the need to exit to raise liquidity for employee shares and extra investment funds. NFC also provides interesting insight into the motivational effects of bonus-related pay as opposed to employee share ownership. This case provides some support for Proposition 2. Proposition 4 and the evidence presented earlier suggested that NFC may have been expected to exit early. That it took a relatively long time for the company to exit highlights the interaction with other factors, most notably initial underpricing and considerable internal generation of funds.

DISCUSSION AND CONCLUSION

The objective of this study was to enhance understanding of the factors impacting upon the longevity of buy-outs by considering the whole spectrum of the management buy-out market in the U.K. The empirical material presented is intended to provide preliminary evidence relating to the propositions derived from the review of conceptual issues, rather than definitive tests. Nevertheless, with this caveat, the literature review and the quantitative and case study analysis presented here suggests that while some buy-outs are long lived there may be very strong ownership, financial and market-related reasons why an initial buy-out structure should change. To summarize, the material presented in the paper suggests the following.

The quantitative data presented illustrates significant differences in the longevity of large and small buy-outs. Buy-outs arising on privatization from the public sector and from non-U.K. parents were found to have significantly greater exit rates than buy-outs from other sources, highlighting perhaps the greater constraints on these kinds of firms. In contrast, buy-outs of privately owned firms were found to have significantly lower exit rates. The review of the literature and the case studies suggests that in respect of ownership and financial factors: the more the financing institution is driven by a need to earn high internal rates of return on its investments, the sooner will it wish to exit; the lower the managerial equity holding in the buy-out, the lower control they have and the less will management be able to assert their objectives so that exit will be earlier. Concerning competitive and other market factors, the evidence presented here provides support for the following: the more rapidly changing is the market with consequent implications for capital investment to achieve 'critical mass' the earlier is exit likely to be; the more rapid is company growth, and hence the need for resources which cannot be generated internally, the earlier is exit likely to be, this pressure will be greater the smaller is the buy-out in relation to the market and the greater is merger activity in creating increasing importance of size; the greater the intensity of merger activity the more likely is exit price to be bid up beyond original plans and the earlier is exit likely to be. The discussion in our case studies also provided some tentative insights into other management and employee factors.

Ownership/financial factors, competitive and other market factors, and management and employee factors have clear implications for the appropriate governance structure and hence eventual performance. The greater the degree of environmental dynamism, the greater the conflicts on objectives of the parties to a buy-out which had to be supressed at the time of the transaction, the more the governance structure has to be able to respond and be flexible. Future research needs to devote attention to identifying the relative importance of each of the above findings and propositions and in exploring the interactions between their component elements. In particular, issues requiring further testing which have been generated by the background literature and the cases concern: the link between the need for asset sales to pay down debt to be made at predicated prices and exit timing; the link between asset specificity, saleability and exit timing; the influence of underpricing of the initial buy-out transaction on the timing of exit; the influence of buy-out team members' objectives concerning career development, on exit, particularly in smaller buy-outs; the link between differences in the objectives of individual members and exit; and the link between specific managerial skills, alternative employment opportunities, ability to resist unwelcome takeover bids and the timing of exit.

Further systematic research is required to examine in more detail the relationships between these factors, the relative longevity of different forms of buy-out and with variables introduced to control for industry, size of firm, performance, etc. Such a research agenda would provide a more comprehensive analysis of the potential of buy-outs, their longevity and heterogeneity, than a narrow focus on only one form of the phenomenon.

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