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2015

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Rashid, Mamunur; Bairagi, Ranajit Kumar; and Bose, Tarun Kanti, "Going Private Transactions and Private Equity Takeovers: What Have We Learned?" (2015). *Publications and Scholarship*. 22.
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© Business Review : Volume 10. Number 01 & 02, January to December. 2015. pp. 55-67, Business Administration Discipline. Khulna University, Khulna-9208 (ISSN 1811-3788)

business
REVIEW
a journal of business administration discipline

Going Private Transactions and Private Equity Takeovers: What Have We Learned?

Mamunur Rashid[1], Ranajit Kumar Bairagi[2], Tarun Kanti Bose[3].

Abstract

Purpose: *This study was directed towards uncovering the previous studies carried out in relation with going private transactions.*

Design: *A qualitative literature review method has been utilized to serve the objectives.*

Findings: *The review of literature in this paper uncovers the research related to going private transactions. Private Equity is the one dimension, of going private transactions, that has attracted little attention thus far. Given the dynamism in PE transactions and a dearth of research in this area, the proposed study will extend prior research by using more relevant, recent and large-scale data and is expected to bring new insights into the corporate finance literature in terms of the nature and implications of PE takeovers in Australia.*

Originality:

A comprehensive review of the extant literature, being carried out in this paper, reveals that no studies have been conducted to investigate the link among undervaluation, incentive alignment, governance mechanisms and private equity takeovers.

Key Words: Private Equity, Going Private Transactions, Managerial Ownership

Introduction

The recent rise in private equity (PE) transactions internationally has raised concerns not only in the academic literature but also in the proceedings of the regulatory authorities of some of the developed economies. These concerns articulate the need for an evaluation of these transactions on organizations and society (Cumming et al, 2007). The most common form of PE takeovers is the public-to-private (PTP) transaction which takes place when a publicly quoted company is taken over by PE firm(s), the target company goes private and is delisted from the stock market (Frankfurter and Gunay, 1992). During the 1980s, a huge number of public companies went private through leveraged buyouts (LBOs). The reason behind this, as it is argued, was the development of the junk bond market. The going private transactions have been refueled by the development of PE market after the 2000s. With an increase in the size and growth of this market, it becomes increasingly important to understand the economic forces that drive a firm to go from public to private (Bharath and Dittmar, 2010). In this paper, we review the current literature on PTPs through PE firms and outline some future research agenda on this aspect. In particular, we focus our attention to agency issues related to the PE takeovers.

The emergence of PTPs has created a lasting impact not only on the operation of market for corporate control but also on the nature of internal governance. There is evidence that firms subject to PTPs may have inferior internal governance mechanisms prior to going private. PE firms with specialist monitoring expertise and contractual mechanisms represent a new external governance mechanism that involves taking these firms private and improving

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their internal governance (Short et al. 1999). During the 1990s and since, there have been improvements in corporate governance structures and active monitoring by institutional investors; this has led to a reduction in the need for

organizational restructuring (Holmstrom and Kaplan 2001). There was also a trend toward managerial compensation to be tied to performance through stock options and other equity-based compensation. This facilitated a better management compensation schemes (Murphy, 1999) and was expected to have reduced the need for going-private transactions. Nevertheless to date, PE takeovers, i.e., PTP transactions have not been reduced. It is argued that the incentive to mitigate agency conflicts and to remove information asymmetries between managers and shareholders have been the root causes for going-private transactions. In addition, publicly listed firms failing to sustain sufficient financial interest and visibility are more likely to undertake PTP transactions (Mehran and Peristiani, 2010). Literature on PE and going private transactions focuses primarily on the implications of agency conflicts between principals and agents (see, for example, Lehn and Poulsen 1989; Halpern et al. 1999). The existence of agency problems might lead management to invest undistributed funds in noisy projects. One way in which agency costs could be reduced would be from lower information costs as a result of having less disclosure costs and a reduced need to comply with various regulatory bodies (Weir et al. 2005a). Growth prospects are also an important factor in the decision to go private (Mehran and Peristiani, 2010). Lowenstein (1985) concluded that since PTP transactions eliminate asymmetric information between managers and shareholders, and thereby remove undervaluation, the presence of information asymmetries may provide incentives for managers to manipulate information to lower the value of the firm before they take the firm private for their own benefit. In addition, Asquith and Wizmann (1990) pointed out that financial leverage, used in most PE transactions, enables management to transfer wealth from bondholders to equity holders.

Evidence (Bharat and Dittmar, 2010) suggests that firms are more likely to go private when cost of information is very high; i.e., firms have less information available about them in the public market. Specifically, firms will be more interested in going private if market incorrectly values their prospect with less analyst coverage. Leland and Pyle (1977) argued that this information asymmetry increases the adverse selection cost for the investors since this type of firm has low financial visibility (in terms of low analyst following). As a result, these firms will be more likely to go private to avoid the adverse selection costs. Merton (1987) noted the same evidence by arguing that the benefit of being public is diminished for firms with high ownership concentration or lower investor recognition (information asymmetry) and, as a result, these firms are more likely to be involved in going-private transactions. In addition, studies on going private transactions suggest that LBOs increase efficiency with the presence of higher debt payments and alignment of the management incentives by increased ownership stakes (Jensen 1986). Thus, an important explanation for going private is to improve the incentive alignment and governance structure of the firm. This issue is particularly important for firms with high free cash flow, where the excess cash can more easily destroy value by wasting accessible cash flow; a view well supported by Lehn and Poulsen (1989).

Other explanations for going-private transactions include the elimination of widespread publicly traded ownership and reduction of agency costs which arise from the separation of ownership and control (Jensen, 1986). Jensen (1986) argued that elimination of widespread public ownership can reduce expected agency costs and create wealth. Going-private transactions also have an impact on the employment status. Empirical evidence on employment is consistent with the view that private equity portfolio companies create economic value by operating more efficiently (Kaplan and Strömberg, 2009). However, other possible explanations include taxation considerations, thus creating efficiency in operations. Going-private also may occur as a form of takeover defense (Eddy et al. 1996). Thus, Jensen (1989) rightly pointed out that the emergence of PE backed buyouts could lead to the eclipse of public corporation. However, the literature indicates that different factors drive PTPs in different countries having different institutional arrangements (Weir et al. 2005a). The remainder of this paper is structured as follows. Section 2 provides a background to PE transactions. Section 3 is the review of literature that establishes a foundation for the

Ɔ Business Review : Volume 10. Number 01 & 02, January to December. 2015. pp. 55-67, Business Administration Discipline. Khulna Jniversity, Khulna-9208 (ISSN 1811-3788)

levelopment of empirical propositions. The theory and hypothesis development is described in Section 4. Conclusions are presented in Section 5.

Private Equity Transactions

A private equity firm is usually organized as a partnership or limited liability corporation (Kaplan and Stromberg, 2009). Jensen (1989) describes these firms as decentralized organizations with relatively few investment professionals. The private equity firms raise equity capital through private equity funds. In its legal form, private equity funds are organized as limited partnerships where the general partners manage the fund and limited partners provide most of the capital. The limited partners may include institutional investors and, in some cases, wealthy individuals. The private equity firm usually serves as the fund's general partner. The general partner is compensated in three ways. First, the general partner earns a management fee as a percentage of the equity provided plus a percentage of equity employed on realized investments. Second, the general partner earns a share of the profits of the fund. Finally, some general partners charge dealing and monitoring fees to the companies in which they invest. The private equity firm buys majority control of an existing or mature firm using a relatively small portion of equity and a large portion of outside debt financing, sometimes as large as 90%. This arrangement is different from venture capital firms and is termed as leverage buyout (LBO) (Kaplan and Stromberg, 2009). On this basis, the PE firms are generally referred to as LBO investment firms in academic literature. As LBO activity increased after the 1980s, Jensen (1989) believed that the LBO organizations would eventually dominate the corporate organizational form; he argued that the PE firm possesses concentrated ownership stakes with high-powered incentives for management at low overhead costs. PE firm apply performance-based managerial compensation, highly leveraged capital structure and active governance to the companies in which they invest. Despite a few incidents of default and bankruptcy during the later 1980s and early 1990s, PE firms have continued their LBO transactions until now. In 2006 and 2007, a record amount of capital was committed internationally to LBO transactions through private equity firms (Kaplan and Stromberg, 2009).

A considerable increase in PE takeovers through LBOs in the 1980s is an indication that these transactions are a significant tool for corporate restructuring. PE investors and buyout specialists extracted value through reorganization and modernized the sluggish low-growth public firms into more efficient private companies (Mehran and Peristiani, 2010). In effect, PE firms use their industry and operating knowledge to identify attractive investments and develop value creation plans for those investments. They consider the elements of cost-cutting opportunities and productivity improvements, acquisition opportunities, as well as management changes and upgrades (see Acharya and Kehoe, 2008; Gadiesh and MacArthur, 2008). Cumming et al. (2007) concluded that PE takeovers (including MBOs; management buyouts) through LBOs enhance performance and have a profound effect on work practices. Interestingly, as Mehran and Peristiani (2010) pointed out, the decision to go private through PE takeovers lies in the hands of insiders and managers seeking a more efficient corporate structure and better value for their company.

Figure 1 below shows the number and value of worldwide LBO transactions backed by PE firms. A total of 17,171 PE backed buyout transactions occurred from 01 January 1970 to 30 June 2007. Transaction Values are (Enterprise Value of the Target Firms = Market value of equity + Book value of debt – Cash) converted into 2007 US dollars. It is evident that the transaction values peaked in 1988; dropped during the early 1990s, rose and peaked in the later 1990s, dropped in the early 2000s; and increased dramatically from 2004 until recently. From 2005 through June 2007, a record 5,188 buyout transactions occurred at a combined estimated enterprise value of over $1.6 trillion (in 2007 dollars) and this accounts for around 30% of the total transactions occurred during the period of 1985 to 2007.

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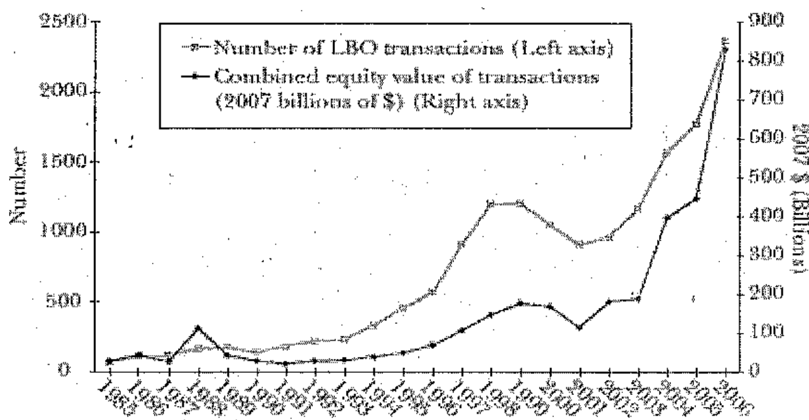

Figure 1: Global PE Transaction Volume (1985 - 2006)
Source: Kaplan and Stromberg, 2009

Table 1 shows the transaction characteristics of global LBOs. The USA and Canada constitute the major portion of LBO transactions worldwide. The increased expansion in PE markets from 2005 to 2007 magnified many different trends. PTPs and secondary buyouts grew rapidly in numbers and size and buyouts in non-manufacturing industries continued to grow in relative importance. Like other developed economics, Australia also experienced a steady increase in LBOs after 2000s. Along with this, PE activity also spreads to some of the new regions of the world (Kaplan and Stromberg, 2009).

Table 1: Global LBO Characteristics over Time

	1985–1989	*1990–1994*	*1995–1999*	*2000–2004*	*2005–6/30/2007*	*1970–6/30/2007*
Combined enterprise value	$257,214	$148,614	$553,852	$1,055,070	$1,563,250	$3,616,787
Number of transactions	642	2,123	4,348	5,673	5,188	17,171
LBOs by type: (% of combined enterprise value)						
Public to private	49%	9%	15%	18%	34%	27%
Independent private	31%	54%	44%	19%	14%	23%
Divisional	17%	31%	27%	41%	25%	30%
Secondary	2%	6%	13%	20%	26%	20%
Distressed	0%	1%	1%	2%	1%	1%
LBOs by target location: (% of combined enterprise value)						
United States and Canada	87%	72%	60%	44%	47%	52%
United Kingdom	7%	13%	16%	17%	15%	15%
Western Europe (except UK)	3%	13%	20%	32%	30%	26%
Asia and Australia	3%	1%	2%	4%	6%	4%
Rest of World	0%	2%	2%	3%	3%	3%

Source: Kaplan and Stromberg, 2009

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Jensen (1989) argues that PE firms apply financial, governance and operational engineering to their portfolio companies and, in the process, improve firm operations and create economic value. In addition, some argue that PE firms take advantage of tax breaks and superior information (Kaplan and Stromberg, 2009). Typically they give the management team a large equity upside through stocks and options (Jensen and Murphy, 1990). PE firms also require management to make a meaningful investment in the company, so that management has a significant stake in the company's profitable operations. This equity stake reduces management's incentive to manipulate short-term performance (Kaplan, 1989). Moreover, leverage creates pressure on managers not to waste money, because they must make interest and principal payments (Kaplan and Stromberg, 2009). This pressure reduces the 'free cash flow' problems described by Jensen (1986), in which management teams in mature industries with weak corporate governance could dissipate cash flows rather than returning them to investors. Axelson et al. (2009) also argue that leverage provides discipline to the acquiring LBO fund. In addition, PE investors control the boards of their portfolio companies and are actively involved in their internal governance structure. PE Portfolio Company boards are smaller than comparable public company boards and meet more frequently (see Gertner and Kaplan, 1996; Acharya and Kehoe, 2008; Cornelli and Karakas, 2008) thereby creating more transparent and operationally efficient internal governance structure.

Empirical evidence on post-operating performance of companies taken over through LBOs is largely positive. For US PTP deals in the 1980s, Kaplan (1989) finds that the ratio of operating income to sales increased by 10 to 20 percent. Lichtenberg and Siegel (1990) find that LBOs experience significant increases in total factor productivity after the buyout. In a more recent PTP buyout study, Guo et al. (2007) find modest increases in operating and cash flow margins that are much smaller than those found in the 1980s in the US. Acharya and Kehoe (2008) and Weir et al. (2007) find similarly modest operating improvements for PTP deals in the UK during the early 2000s. Overall, the empirical evidence is largely in support of the presence of operating and productivity improvements after LBOs.

Review of Literature

In his noteworthy paper 'The eclipse of the public corporation', Jensen (1989) expected that LBOs would become he dominant corporate organizational form in course of time. With better corporate governance practice, concentrated ownership by active owners, strong managerial incentives and efficient capital structure, Jensen elieved that the LBO-form would be superior to the public corporation where there are dispersed shareholders and weak governance. While the literature indicates much effort has been put to shed light on various aspects of the LBOs and PE transactions after Jensen (1989), there are no clear answers to the questions of whether the level of nanagerial ownership in public firms has any impact in a going-private decision or having private information by nanagers of public firms has any impact in a going-private decision. Weir and Wright (2006) reported that PTPs had ower valuations than traditional acquisition of listed corporations by other corporations. This suggests the existence of managerial private information. Interestingly, Australian PTP evidence indicates that insider ownership is not ignificantly higher in PTPs than for traditional acquisitions of listed corporations (Evans et al. 2005).

'he literature on PE suggests there are various aspects to theses transactions. One aspect deals with free cash flow which argues that before going private through PE, agency costs were prevalent in target firms because free cash lows were spent on noisy projects (Jensen, 1986). These firms are expected to have low growth opportunities and arge free cash flows; the later being used to achieve managerial objectives rather than shareholder wealth naximization. Management would only consider a move away from this situation if faced with an increased threat f a hostile takeover (Weir et al. 2005a). Lehn and Poulsen (1989) and Singh (1990) also supported this by saying hat firms going private have greater free cash flow than firms remaining public. On the other hand, Kieschnick 1998) found free cash flow and sales growth to be insignificant in PTPs. In addition, Opler and Titman (1993) ound no evidence that free cash flow or Tobin's Q influence the decision to go private. Interestingly, they found hat LBOs are more likely to have the combined characteristics of low Q and high cash flow than firms remaining

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public. Thus there is a mixed conclusion that PTPs exhibit high free cash flow and low growth prospects. Another aspect deals with the wealth gains in PTPs. Evidence suggests that shareholders of PTP firms make significant wealth gains. DeAngelo et al. (1984) found significant positive returns on the announcement, while Torabzadeh and Bertin (1987) found that significant abnormal returns accrue to the shareholders of PTP targets if financed by debt. Frankfurter and Gunay (1992) suggested that insiders and outsider shareholders gain after the PTP takes place. In effect, there is strong evidence that PTPs do generate gains to insiders and outsider shareholders, which suggests that managers have strong incentives to take their firm private. Another aspect of PE transactions deals with the market for corporate control, which is based on the idea that takeover bids are disciplinary and, therefore, hostile. If PTP firms had been the subject of takeover speculation whilst still publicly quoted, they were meant to have ineffective internal governance mechanisms. A number of studies (see Lehn and Poulsen, 1989; Singh, 1990; Halpern et al. 1999) have reported that companies that went private were more likely to experience takeover speculation than firms that did not; but they could not confirm whether all the speculations were hostile (Weir et al. 2005a).

One aspect of the agency problem that has received little attention is the link between ownership structures, managerial private information and the going private decision. Table 2 exhibits a summary of the literature reviewed on the agency conflict and PE takeovers:

Table 2: Literature on Agency Issue and PE Takeovers

Authors	Focus	Outcome
Maupin, 1987 (USA)	Characteristics of going private firms that distinguish them from firms that remain public	High Ownership concentration, high cash flow to net worth, high cash flow to assets, low P/É ratio are the factors that distinguish PTPs from firms remaining public.
Malone, 1989 (USA)	Characteristics of Smaller PE-backed LBOs	Management ownership stake plays important role in post buy-out changes.
Marais et al. 1989 (USA)	Wealth expropriation from bondholders through LBOs	No evidence was found that LBOs transfer wealth from pre-buyout bondholders to the shareholders.
Lehn and Poulsen, 1989 (USA)	Sources of stockholder gains in PTPs	A significant relationship exists between undistributed cash flow and the decision to go private. Moreover, premiums paid to stockholders are significantly related to undistributed cash flow.
Singh, 1990 (USA)	Characteristics of firms bought out by their management (MBOs)	Firms going private tend to have higher levels of cash flow as a percentage of sales and have a significantly higher incidence of takeover speculation prior to the buyout.
Opler and Titman, 1993 (USA)	Motivations for LBO activities in comparison to those that have not implemented LBO	Firms with high free cash flow and low Tobin's q are more likely to undertake an LBO. It was also found that financial distress costs deter LBOs and this suggests that debt financing is crucial for realizing the gains from going private.
Eddey et al. 1996 (Australia)	The motivations for going private transactions	Going private transaction is frequently preceded by the threat of a takeover offer. No direct evidence was found to support the free cash flow explanation for going private. An alternative explanation may be the exploitation of inside information by managers and/or directors.

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Halpern et al. 1999 (USA)	Differential characteristics of firms going private through LBO	LBO population is heterogeneous. For firms with low managerial stake, outside takeover pressures force management to consider a buyout of the firm or face the prospect of a hostile takeover. For firms with high managerial stake, management has incentive to take cash out of their firm by taking it private through an LBO.
Weir et al. 2005a (UK)	The motivations for going private transactions	Higher CEO ownership, higher institutional blockholder ownership, more duality of CEO and Board Chair, no difference in outside directors or takeover threats.
Weir et al. 2005b (UK)	Valuation, agency costs and ownership structures of firms going private	Firms going private suffer from undervaluation; have poor internal governance structure but no takeover threat.
Evans et al. 2005 (Australia)	Assessing the characteristics of firms going private	High liquidity, lower growth rates, low leverage and R&D expenses. Free cash flow is not significant and takeover threats are less likely.
Weir and Wright, 2006 (UK)	Internal and external governance and other characteristics of PTPs	PTPs have higher board ownership, CEO-chair duality, low growth prospects and low valuations; but no poor governance structure or takeover threat.
Renneboog et al. 2007 (UK)	The magnitude and sources of expected shareholder gains in PTPs	Shareholder wealth gains are undervaluation of the pre-transaction target firm, increased interest tax shields and incentive realignment.
Eidrmüc et al. 2007 (UK)	Motivations for PE investors to take a firm private	High executive ownership and high ownership by financial institutions, lower ownership concentration in target firms with shortage of cash, low debt levels and high dividends.
Toby and Soojin, 2010 (USA)	Effect of board networks on likelihood of being PE targeted	Companies with PE deal experienced directors are more likely to receive PE offers; board members' social networks influence which companies become takeover targets.
Chapple et al. 2010 (Australia)	Pattern of selection of target firms by PE investors	PE target firms are more profitable, use their assets more efficiently and have greater cash flow; with relatively greater financial slack, greater financial stability and greater free cash flow.

Current literature indicates that the majority of research on 'going-private' transactions has focused on either the motivation behind going private deals or its consequences; it has focused on the financial and governance characteristics of firms going private, the fairness of the price paid to the minority shareholders, analysis of cost and benefits of the change and the resulting financial performance. A few studies have explicitly attempted to uncover the characteristics of firms involved in going private transactions. A possible reason for the lack of research in the area is the difficulty of obtaining public information on PE takeovers. Thus, despite the existence of a number of studies on the financial and governance characteristics of target firms in PE transactions, we are not aware of any research linking the relationship between high managerial ownership, information asymmetry and proximity of the firms to be involved in going-private transactions.

Empirical Propositions and Variable Measurements

Traditionally, firms involved in PTP transactions have had a higher level of agency costs in terms of incentive

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misalignment and poor monitoring than traditional acquisitions of listed corporations (Jensen, 1986). Firms going private are expected to be in mature, low growth sectors with high free cash flow, with PTP transaction enabling the return of the free cash flow to shareholders as a result of improved governance and incentive realignment post-buy-out (Weir and Wright, 2006). The review of recent empirical evidence (e.g., research shown in Table 2) indicates that buyouts and private equity transactions appear to be associated with incentive and governance mechanisms that enhance performance. An ongoing debate concerns whether the gains resulting from the implementation of new governance mechanisms after buyouts can be obtained without actually taking the firm private (Jensen et al. 2006).

Managers with high ownership stakes could have a strong incentive to secure PE-led bids with a view to increasing their own wealth together with the controlling interest in the firm (Toby and Soojin, 2010). Targets in PE-backed deals have high executive ownership and high ownership by financial institutions but have lower ownership concentration (Fidrmuc et al. 2007). Toby and Soojin (2010) reported that PE firms could be most attracted to targets with large shareholders because mobilizing support for such transactions could be comparatively simple. Evidence indicates that firms involved in PTP transactions have significantly higher managerial share ownership than those involved in traditional acquisitions of listed corporations (Maupin, 1987; Halpern et al. 1999). Specifically with respect to PTP, Halpern et al. (1999) reported that firms involved in LBOs have significantly higher managerial share ownership than those involved in traditional acquisitions of listed corporations. Therefore, firms with higher managerial ownership will have incentives to take firms private. A study by Maupin et al. (1984) also supported the argument that managers with high levels of ownership would be more likely to stage a PTP transaction. In effect, the evidence suggests that high insider ownership by managers and boards might create incentives for the management to go for MBOs or PE-backed deals. O'Sullivan and Wong (1998) found that the level of managerial ownership plays an important role in takeover bids. In respect of bid outcome, they also found that executive share ownership is positively related to takeover success. Manry and Nathan (1999) found that a large ownership stake by managers may induce entrenchment and this is consistent with the fact that increasing managerial ownership induces management to become entrenched as suggested by Morck et al. (1988). Morck et al. (1988) argued that with low shareholdings by management, an increase in shareholdings may increase their motivation to work more closely for the improvement of shareholder wealth; but with larger shareholdings by management, an increase in shareholdings may induce management to become more entrenched. Some researchers have indicated that managerial shareholdings may create a trade-off between managerial incentives and entrenchment. With high level of ownership, managers may have incentives to transfer the resources of the firm to other companies under their full control (Filatotchev et al. 1999). In addition, Halpern et al. (1999) also noted that companies with high managerial ownership are found to be involved in LBOs voluntarily, while companies with low managerial equity ownership are found to be vulnerable to a hostile takeover. Thus, it is hypothesized that managers with a high level of shareholdings, after a critical entrenchment level, are more likely to take the firm private through PE-backed deals, though managers with a low level of ownership would not do so:

Hypothesis 01: Firms with high managerial ownership are more likely to take the firm private through PE-backed deal.

The relationship between corporate governance and leverage has been investigated extensively in the literature. Use of debt effectively binds managers to carry out their promise to pay out future cash flows. Hence, debt financing is an effective way to reduce agency costs of free cash flows. This benefit of using debt is known as 'control hypotheses'. Reduction in leverage brings more cash flow under the control of managers and increases the agency cost of free cash flows (Jensen, 1986). Prior research suggests that corporate leverage can act as a self-disciplining internal governance mechanism to mitigate the agency costs. Although leverage does not necessarily play a significant governance role, strong corporate governance may often lead to higher leverage. It is argued that managers usually have incentives to keep borrowing at lower levels rather than optimal because this reduces the probability of bankruptcy and provides managers with a greater discretion over the use of excess cash. Therefore, it

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is expected that firms with entrenched managers are likely to have low leverage (Florackis and Ozkan, 2009). With low levels of debt and an increased level of free cash flow, managerial discretion is increased which may lead managers to the route of opportunity to obtain 'rents' and thereby follows the managerial entrenchment theory as suggested by Shleifer and Vishny (1989). Thus, it is hypothesized that entrenched managers in terms of a high equity stake, will use less amounts of debt in their capital structure; this leads to develop the following hypothesis:

Hypothesis 02: Target Firms in a PE led bid are more likely to have lower levels of debt.
Critics of private equity transactions often claim that private equity investors make proper use of superior information on future portfolio company performance where incumbent management is a source of the private information. It is argued that incumbent management has information on how to make a firm perform better. Since, one of the justifications for private equity deals is that with better incentives and closer monitoring, managers will use their knowledge to deliver better results. However, another justification is that incumbent managers favour a private equity buyout because they intend to keep their jobs and receive lucrative compensation under the new owners (Kaplan and Stromberg, 2009). Thus, managers may have an incentive to take the firm private in order to eliminate information asymmetry resulting from the situation where information about managerial performance and/or investment opportunities is not correctly transmitted to outside shareholders (DeAngelo et al., 1984). Having their discretionary power, managers would try to use such discretion to enhance their income. One better way to do it is to invest in projects where information asymmetries are large and, as such, it would be difficult for rival managers to manage such projects (Edlin and Stiglitz, 1995). Moreover, if management believe that the firm is being undervalued by the market, they may seek to realise some capital gains by taking the firm private. Because of the information asymmetry between management and outside shareholders about the true and intrinsic value of the firm, management actually can send a signal to the market by attempting a going private transaction (Evans et al, 2005). With the existence of information asymmetry, incumbent management may see listing costs as an unnecessary burden (Weir and Wright, 2006). DeAngelo et al. (1984) noted that the costs of maintaining a stock exchange listing are very high. Depending on the size of the company, for UK quoted firms, the listing costs in terms of fees paid to stockbrokers, registrars, lawyers, merchant bankers and financial companies, as well as the exchange fee and the auditing, printing and distribution of accounts, can be very high and might even affect the profitability of the firms. Renneboog et al. (2007) suggested that wealth gains from going private are largely the result of the elimination of the direct and indirect costs associated with maintaining a stock exchange listing. Thus, an important explanation for going private by PE-led bids is that incumbent management possess private information, which leads them to believe that the market has an incorrect perspective of the company's prospects. Therefore, delisting would enable the management to operate in conditions that would not carry with them the public perception that the company was a poor performer (Weir and Wright, 2006). Prior studies also report that PTP buyouts had lower valuations than the traditional acquisition of listed corporations by other corporations, indicating managerial private information and suggesting that outside bidders might have been deterred from bidding for the firms because of the potential difficulties involved (Cumming et al, 2007). Thus, it is hypothesized that the presence of information asymmetry between and managers and shareholders will create incentives for the managers to take the firm private through a PE-backed deal. The presence of information asymmetry can be explained as having low growth prospects and the following hypothesis is proposed:

Hypothesis 03: The target firms in a PE-led bid would have low growth prospects.
PE takeovers appear to occupy an unusual place in the market as disciplinary, friendly acquirers. They do not appear to focus on particular industries and this means that the synergistic motive is less plausible. Accordingly, PE bidders appear to play an 'opportunistic' role not clearly explained by either the disciplinary or synergistic hypothesis (Chapple et al, 2010). This leads to the fact that the firms being engaged in PE-backed deals will have high free cash flows and poor internal governance structure. The free cash flow theory also tells us that the likely LBO candidates tend to underutilise their debt capacity. Therefore, it is expected that such firms have low debt levels and high free

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cash flows (Myer and Majluf, 1984). Evidence suggests that firms going private are more likely to have higher CEO shareholdings, higher institutional shareholdings, more duality and lower Q ratios (Weir, et al. 2005a). Evidence in support of the free cash flow theory explanation for going private is offered by Lehn and Poulsen (1989) and Opler and Titman (1993). Thus, it is hypothesized that the target firms with high managerial ownership and private information would have high free cash flows and poor internal governance structure to attract PE-backed deals:

Hypothesis 04: The target firms in a PE-led bid have high free cash flows.

Hypothesis 05: The target firms in a PE-led bid have ineffective board governance structure.

The empirical propositions presented above suggest managers with high ownership will initiate a going private transaction through PE led bid; but mangers with low level of ownership will not do so. The managerial ownership variable should be used as a percentage of total shares outstanding. The board ownership variable should also be used as a percentage of total shares outstanding, but as a control variable only to ensure that impact of managerial ownership alone is determined. The propositions also suggest that the firms undertaking a going private transaction are likely to have low levels of debt, lower measurable growth prospects, high free cash flow and poor governance structure. To test these propositions, following procedures are recommended. First, for debt levels, one should use the debt-to-equity ratio (Chapple et al. 2010). Based on hypothesis 2, we expect the debt-to-equity ratio to be lower for the firms initiating going private transactions. For proposition 3, we expect PE targets to exhibit high dividend payout and low price-earnings ratios as suggested by Chapple et al. (2010). They (Chapple et al. 2010) argued that firms that pay higher dividends tend to be in mature industries with low growth prospects; while low price-earnings ratios are expected to be associated with low value stocks. We also consider going private firm's growth prospects using its market-to-book ratio which has been widely used to proxy for a firm's investment opportunities or growth potential (see e.g. Comment and Schwert, 1995; Chapple et al. 2010). Since we hypothesize that the going private firms would have lower measurable growth prospects, we expect the PE target firms to have a relatively lower market-to-book ratio. For proposition 4, one should use accounting cash flow (Evans et al. 2005) to proxy for the free cash flow and we expect the PE target firms to have larger accounting cash flows.

Conclusion

The existing research on going private transactions, in general, has looked into the financial and governance characteristics of PTPs, as denoted by Evans et al. (2005). Most of those studies focused on LBOs, MBOs, MBIs and other dimensions of US and UK going private deals with a little attention to PE deals. In addition, Australian studies on going private transactions exhibit only one empirical study (see, e.g., Chapple et al. 2010) on PE deals thus far, exploring the financial and governance characteristics of Australian PE deals. A possible reason for the lack of research in this area is the difficulty of obtaining public information on PTPs. Henceforth, private equity is the one dimension of going private transactions that has received little attention in the academic literature, and in particular in Australian going private studies. Considering the recent surge and significance of PE investments worldwide (Kaplan and Stromberg, 2009), formal studies into the nature and interplay of these investments are warranted. In addition, with an increase in the size and growth of this market, it becomes increasingly important to understand the economic forces that drive a firm to go from public to private (Bharath and Dittmar, 2010). In this paper, the importance of high managerial ownership and managerial private information are highlighted as determining factors for a public firm in going-private decision and, in particular, being taken over by a PE firm from the Australian context. The proposed study is expected to bring new insights in the corporate finance literature in terms of the nature of going private firms in Australia.

Based on the framework for this study, along with the related academic literature and anecdotal evidence on PE takeovers, it is expected that a significant relationship between the decision of a firm to go private and the level of managerial ownership will be found. Similarly, it is expected that the presence of information asymmetry between

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the managers and shareholders plays a crucial role in the going-private decision by a publicly listed company. One possible explanation for this situation is the belief by managers that the market has significantly undervalued their firms. An important explanation for going private by PE-backed deals (Weir and Wright, 2006) is that incumbent management possesses private information which leads them to believe that the market has an incorrect perspective of the company's prospects. Therefore, delisting would enable the management to operate in conditions that would not carry forward the public perception that the company was performing poorly.

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