

ROTTERDAM SCHOOL OF MANAGEMENT, ERASMUS UNIVERSITY

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The business school that thinks and lives in the future

MBOs, private equity and entrepreneurial management

by Hans Bruining, Ernst Verwaal and Mike Wright

Critics claim that short-term profit orientation and high deal price strategies of private equity firms can negatively affect the ability of management buy-outs to initiate and sustain entrepreneurial management. However, as our research shows, this is not the case.

The majority of private equity-backed management buy-outs are associated with significant increases in entrepreneurial practices which help grow a successful business or turn round a failing one. This is in addition to the more readily recognised impact they have on administrative management practices, which focus largely on cutting costs and increasing efficiencies.

These are two of the principal conclusions of a study we carried out on private equity and entrepreneurial management in management buy-outs in 2011, which will have important implications for years to come.

Policy makers involved in issues relating to the private equity industry should be aware of, and take into account in their thinking, the results of the study, which contradict some of the criticisms voiced by regulatory authorities, and some politicians and trade unions regarding the effect of private equity and buy-outs.

According to the CEOs of the buy-outs we studied, private equity firms

do not reduce the chances of bought-out firms initiating and sustaining entrepreneurial activity. Further, private equity firms may exercise administrative management to manage the debt level if the buy-outs involve very high leverage.

The scientific background to our study, *Private equity and entrepreneurial management in management buy-outs*, is based on the investigation of spurious relationships. Some people might be bald, and have dementia, for example, but one does not cause the other. Private equity firms often use leverage, high levels of leverage, as part of their business model, partly because of the fiscal benefits that accrue to debt. However, other firms pursue equity-only models.

We wanted to separate the effect on the outcome of financial leverage on the one hand, and private equity as a governance form on the other. We show that private equity should not be condemned on the basis of its use of leverage. Additionally, private equity as a governance strategy helps firms re-

energise and become more efficient, by acting as an instrument to increase the control that the ultimate owners have over the managers.

Removing the agency costs embedded in the disconnection between shareholders and managers is only the first step in the process. It is not only efficiency that increases through private equity involvement, but also entrepreneurial activity. Managers behave differently when they own a company. The results of our study support the notion that private equity firms help buy-out companies develop ambidextrous organisational change.

We recommend, however, that because of the sample size limitations, further research is needed to establish if financial leverage has a negative effect on entrepreneurial management for minority private equity-backed companies and non-private equity-backed companies.

One surprising discovery made during the study was that despite the various stimuli affecting an individual company following a buy-out, despite the increase measured in entrepreneurial activity, it was not uncommon for a company's entrepreneurial culture to become more conservative.

Our explanation for this is based on the observation that private equity activity is concentrated mostly



in mature industries (radical new ideas are not such a good fit with mature industries). More influential cornerstones for revitalising existing business are: rethinking the business ideas, the products, the markets, the organisation, the core expertise, the managerial drive and motivation.

The need to generate cash to service the debt assumed to finance a transaction forces companies to become more efficient. It also stimulates the management board to explore new opportunities rather than limit them, as is too often assumed in uninformed debate by policymakers. For more than two decades at least, it has been said that debt is what gets managers out of their bed every morning. Equity puts them to sleep. This is no less true for having become a firmly established private equity cliché.

Dispelling negative myths

In our study, private equity is used as an organisational refocusing device to strengthen or develop the entrepreneurial and managerial cognition of the CEO post-buyout that, depending on the financial situation, stimulate growth and efficiency. The study's origins lie in the often negative view taken by politicians and other senior influential figures across Europe of the private equity industry.

Some high-profile sceptics accuse private equity investors of pushing companies beyond their natural reach as they focus on their own short-term profit rather than the companies' own long-term growth and development. Our study demonstrates that these criticisms are not based on anything we would regard as the truth.

Rather than focusing on ways to dilute the effectiveness of the private equity industry, critics should instead be considering how it might be encouraged to carry out even more positive work than it already does. For example, in those countries where there are formal limits placed on the proportion of the debt used to finance a transaction that can be set against taxable profits, or plans exist to introduce such limits, the authorities might consider raising those limits rather than reducing them still further. Surveillance by the treasurer is warranted.

The negative image of private equity is, then, not justified. Rather, it should be seen as an important instrument in revitalising industry, especially in countries such as the UK where there are higher numbers of publicly listed companies accounting for a larger share of national output than in, for example, the Netherlands or Germany. Private equity corrects the mistakes made at companies that were previously listed. ■

This article is based on the research paper *Private equity and entrepreneurial management in management buy-outs*, which was published online in *Small Business Economics*, October 2011.

Hans Bruining is Associate Professor of Strategic Management, Department of Strategic Management and Entrepreneurship, Rotterdam School of Management, Erasmus University Rotterdam. Email: jbruining@rsm.nl

Ernst Verwaal is Professor of Strategy and International Business, Research Institute in Economics and Management of Networks and Institutions, Queen's University Management School, Belfast. Email: e.verwaal@qub.ac.uk

Mike Wright is Professor of Entrepreneurship and Director of the Centre for Management Buy-Out Research, Imperial College Business School, London. Email: mike.wright@imperial.ac.uk