

Research Report

Private Equity – Blessing or Curse?

The case of IPOs

WE STUDY WHETHER PRIVATE EQUITY (PE) FIRMS HAVE A POSITIVE IMPACT ON THE FINANCIAL PERFORMANCE OF THEIR GERMAN PORTFOLIO COMPANIES BEFORE AND AFTER THE IPO. OUR EMPIRICAL ANALYSIS IS BASED ON A UNIQUE AND LARGE DATASET OF ALL IPOS IN GERMANY BETWEEN 2000 AND 2007. WE FIND THAT PE FIRMS SELECT COMPANIES WITH BELOW AVERAGE PERFORMANCE AND THEN IMPROVE PERFORMANCE SUBSTANTIALLY UNTIL THE IPO DATE AND IN MANY CASES ALSO THEREAFTER. THIS IMPLIES THAT PE FIRMS FILL A VOID ALSO IN GERMAN FINANCIAL MARKETS AND THAT THEY WILL ALSO PLAY A FUTURE ROLE IN FINANCING GERMAN ENTERPRISES.

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Introduction

Private Equity (PE) firms exert more control over their portfolio companies than most other financial intermediaries. For example, they give strategic guidance, advise their firms on the management team and financial matters and get involved in restructuring activities. Their goal is to increase the value of the portfolio companies and thus to produce superior returns for their own investors (Barry et al., 1990). This value creation can only be realized at the “exit”, i.e. the event at which the PE firm sells off its stake in the respective portfolio company. One of the most profitable and consequently most desired exits is taking the portfolio firm public through an Initial Public Offering (IPO). Selling the shares of an IPO company into the primary

stock market usually results in large profits for the initial shareholders as IPO shares can be sold into the market at a premium over their pre-IPO value. A rule of thumb therefore suggests that the more profitable the IPO company and the more promising the company’s financial future prospects according to its equity story, the higher the price at which the shares can be sold into the market. A PE firm therefore has large incentives to maximize the profitability of its portfolio company around the IPO date. However, although the interests of PE investors and the IPO companies’ management should be largely aligned – increasing profitability and equity value – the PE investor might have additional objectives that can be detrimental to the other stakeholders of the company.

For one, PE investors usually strive to exit their investments at around five years after making the investment. This “deadline” must often be met to generate payouts for the PE funds’ investors, disregarding possible future value increases in the portfolio companies.

Second, a PE firm can benefit from stripping a potential IPO company off certain assets before the IPO to generate pre-IPO returns for its investors, e.g. through extraordinary dividend payments. Disclosure requirements and shareholder or analyst pressure of a public company only allow for these kinds of transactions to be made before the IPO. A PE-backed IPO company might hence be deprived of a best possible performance at the time of the IPO due to these transactions.

And third, PE investors are often accused of boosting short-term profitability at the expense of economically healthy long-term value growth. Following this idea, PE investors might take their portfolio companies public prematurely, based only on short-term artificial growth, e.g. through the sale of valuable assets or one-off balance sheet transactions (Jain and Kini, 1994). These three allegations against PE investors stand in contrast to the initial remark – and empirical fact – that PE firms do create value for their portfolio companies and consequently also for the companies’ other investors. Against the background of these arguments, we compare in our paper the financial performance of IPO companies with and without PE investors at the time of the IPO.

Industry	No.	%	Avg. Age [years]	Avg. Issue Volume [€ Mio.]	# PE-backed IPOs	Length PE-backing [years]
Construction	2	0.81	125	94	1	10
Chemicals	4	1.62	62.3	731	2	3.5
Energy / Commodities	2	0.81	14.5	149	0	0.5
Financial Services	29	11.74	38.1	388	6	4.5
Commerce / Trade	9	3.64	18	152	4	4.3
Industrials	51	20.65	27.9	136	24	2
Consumer Goods	7	2.83	24.4	55	1	2
Media	21	8.50	11.3	253	8	0.6
Pharma / Healthcare	28	11.34	11.9	60	22	2.7
Software	60	24.22	10.5	96	31	1.4
Technology	18	7.29	18.8	1,260	6	2.3
Telecommunications	7	2.83	3.7	1,100	3	1.5
Transport / Logistics	9	3.64	39.8	1,880	2	1.5
Total / Average	247	100	31.3	489	110	

Table 1: Descriptive overview of the sample of 247 IPOs in Germany over the period 2000–2007

Methodology

The goal of our analysis is to answer the question: Do PE-backed companies have a better financial performance than non-PE-backed companies at the time of an IPO? We are able to answer this crucial question regarding the role of PE as a financial intermediary as we base our analyses on an extensive and unique hand-collected dataset of 247 IPOs in Germany over the period 2000 to 2007. Table 1 shows descriptive statistics on the characteristics of the IPOs and outlines the situation in the IPO market during the period covered by our dataset. The results of our analyses are particularly relevant for the role of PE but also for the importance of financial intermediaries in general.

To answer the question raised above, we first need to define how to measure financial performance. We use a total of four balance-sheet based proxy variables to represent performance. The variables are Return on Assets (RoA), Return on Sales (RoS), Cash Flow on Assets (CFoA) and Cash Flow on Sales (CFoS).

We use Propensity Score Matching in order to overcome a possible selection bias induced by the PE company's choice of targets.

Based on the matched data set, various statistical tests are performed in order to answer the question whether or not PE-backed companies perform differently compared to their non-PE backed counterparts in terms of the performance measures given above.

We find significant differences between those two groups and run several regression analy-

	Return on Assets			Return on Sales			Cash Flow on Assets			Cash Flow on Sales		
	PE	Non-PE	Diff.	PE	Non-PE	Diff.	PE	Non-PE	Diff.	PE	Non-PE	Diff.
1) IPO date	-.0856	-.0508	.0347	-2.96	-.2770	2.69***	-.0977	-.0406	.0571***	-.9171	-.1624	.7552***
2) Avg. 5 yrs	-.2597	-.1719	.0877**	-1.94	-.0795	1.86***	-.0970	-.0204	.0766***	-.6476	-.1910	.4560***
3) Increase 5 yrs	.4118	-.1462	.5581***	2.08	-.4524	2.54***	.0441	-.0728	.1169***	.2377	.3730	-.1353

Table 2: For each time period and variable we report the mean at the IPO date, the mean over the entire five year period surrounding the IPO and the absolute change over the five year period. The differences (PE – Non-PE) between the groups are given by t-tests.

ses in order to detect the causes for this heterogeneity. Thereby, we control for several variables and conduct robustness checks to control for the impact of corporate governance structures, the dotcom bubble and its aftermath, differences between Venture Capital and Buy Out investments, as well as the temporal development of the two groups' performances.

Results and Conclusion

Table 2 gives the results of the standard difference-in-mean-tests. The three rows of the table summarize what we also find when we conduct more complex analyses in our paper:

- 1) On the IPO date, PE-backed companies have a lower financial performance than non PE-backed companies. For each of the performance measures, the mean of the non-PE variable is higher than its PE-backed counterpart. This difference is statistically significant for three of the four profitability measures.
- 2) Averaged over the entire observation period of five years (where the IPO date is

always right in the middle), PE-backed firms also trail non PE-backed firms in terms of performance.

- 3) However, when looking at the change in performance over the five-year period (measured as difference between year 5 and year 1 in the third row) we find that PE-backed companies increase profitability whereas average profitability of non-PE-backed companies actually declines for the first three measures.

We thus conclude that PE companies create value by selecting firms with below average performance and by improving their performance substantially until and also beyond the IPO date. Furthermore, we give support to the certification hypothesis which suggests that PE companies ensure a high quality of their targets so that they can tap primary capital markets at an early point in time (Megginson and Weiss, 1991).

Moreover, our results are consistent with the window dressing theory, which posits that

PE-backed companies have less incentives to whitewash the financial statement of their portfolio companies. The major reason is that PE companies would risk their reputation if window-dressing were detected, which would significantly reduce the income from any future IPO.

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