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Private Equity and LBOs: An Efficient Investment Tool Needing Regulation

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Abstract: Private equity funds are becoming more and more significant in the national economy and their role in the development of a country's economy has become increasingly important as a promising new financial draw in the global financial markets in recent years. Private equity firms were established in the US and expanded quickly behind the decade's brisk economic growth. This paper analyzes the pros and cons of private equity and leveraged buyouts, combining case studies, the legal basis and experience of various countries and government regulation, to discuss the problems of private equity investment, clarify the responsibilities of the government, improve relevant laws and regulations, and encourage the private equity market's growth.

Keywords: private equity funds, investment, government regulation, leveraged buyouts

1. Introduction

With the increasing development of private equity and leveraged buyouts as an emerging form of corporate M&A, leveraged buyouts have revealed both benefits and drawbacks at the societal level and at the operational level of the company. Therefore, analyzing the effects of leveraged buyouts and private equity is crucial.

A hostile leveraged buyout known as the "buyout of the century", KKR (Kohlberg Kravis Roberts & Co. L.P) paid a minimal price for the entire acquisition. The most recognizable and well-known private leveraged buyout in history is still the 1989 RJR Nabisco transaction, a $31 billion deal that made Kohlberg, Kravis & Roberts famous on the deal market, a deal that spawned the leveraged buyout boom that followed, a battle that ended with the eventual breakup of RJR Nabisco and KKR vowing never to put so much money into one investment again.

Leveraged buyout (LBOs) is considered to be a jenious and efficient way to purchase a company by low-level leverage. However, because the targeted company's management might not want the purchase to go through, LBOs are also frequently referred to as hostile takeovers. In the past two decades, Private Equity (PE) and LBOs have drawn much attention as the controversial topics. Much research has been done on pros regarding booming company value and benefits for market, but the results of cons and solutions are not satisfactory.

The aim of this essay is to list the benefits and drawbacks of leveraged buyouts through case studies and practical examples, to weigh the pros and cons, and to consider measures to address the disadvantages of leveraged buyouts, the role of government in this regard, and the role of laws and regulations in preventing the adverse effects of leveraged buyouts.

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2. Booming Company Value

2.1. Private Equity Creates Economic Value Overall

Private equity firms improve corporate operations and generate economic value by applying financial, governance, and operational engineering to their portfolio companies [1].

After leveraged buyouts, private equity activity typically results in significant operating improvements [2]. Private equity firms discover appealing investments, create value development plans for those investments, and implement the value creation plans using their understanding of the industry and operating procedures. In addtion to this, leverage creates pressure on managers to use money cautiously, because they must make interest, principal payments and reap benefits [3].

In practice, the leveraged buyout model, which uses financial leverage to finance acquisitions, has become a hit with many SMEs (mall and medium-size enterprise), and debt financing, as the key to the implementation of leveraged buyouts, plays a role in securing funds. More and more companies are using equity pledges to finance leveraged buyouts, but this can easily lead to an overlap of risks, which, if not reasonably and effectively controlled, can result in a leveraged buyout going down the drain.

In general, leveraged buyout events do have a significant effect on a company's short-term market performance, such as an excess increase in stock returns. However, companies should be cautious in their use of leveraged buyout strategies and assess the risks of the acquisition thoroughly. At the same time, the acquisition strategy should be based on the industry trend and the timing of the acquisition should be reasonable.

2.2. Financial Leverage and Tax Deductions Increase Company Value

Leverage has the potential to raise a company's value by allowing interest to be written off against taxes. Leverage boosts business value up to a degree, but it also raises default risk for capital providers who want higher returns as recompense, given that interest is tax deductible.

Theoretically, according to Modigliani and Merton H. Miller for the United States, the benefit of taking on debt is that the interest payments can be utilized to cut taxes, lowering the weighted average cost of capital for the business after taxes. Therefore, the more debt a firm has, the higher the benefit of tax avoidance, and the bigger the company's value.

2.3. The New Way of Private Equity

The new private equity approach is the use of scale funds, capitalizing on their size and breadth. Unlike previous approaches, the new private equity approach brings huge resources through the use of funds and most of them are the most complex and esoteric deals. Companies such as BlackRock, KKR, CVC and EQT, for example, raise tens of billions of dollars and run funds with strong yet professional management teams, waiting for the right time to invest like predators waiting to catch their prey.

For instance, As the most famous investment company, CVC is world-renowned. Through clear and proactive strategies, CVC seeks out companies with promising development prospects, often characterized by stable positions and professional teams.

The CVC team has a wealth of local knowledge and an extensive network of relationships that have underpinned the firm's continued success over 31 years. In its private equity business, the company buys controlling or sizeable minority stakes in North American, European, and Asian businesses through these funds. Through partnerships with company management, the company buys into companies to drive growth and create sustainable long-term value initiatives.

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Through its funds, CVC Credit Partners invests in debt instruments, typically those issued by businesses owned by private equity funds, as part of the company's private debt business. The funds managed by CVC control more than 60 businesses with a combined global workforce of more than 400,000 and combined annual sales of $120 billion. CVC has executed more than 300 acquisitions of businesses around the world.

2.4. Fierce and Brutal Private Equity and Leveraged Buyouts Environment Drives More Professional Management Teams

Increasing competition for deals is driving specialization, which means that management team of private equity firms should more professional, well-organized and competitive when it comes to conditions of leverage buyout. Nowadays, most private equity companies utilize industry and operational expertise to increase investment value [4]. In actuality, the majority of elite private equity firms are now structured by sector. PE firms today frequently employ experts with operational backgrounds and an industry specialization in addition to transaction matchmakers with expertise in financial engineering. In general, a professional and efficient team in turn better generates revenue for the company's benefit.

What’s more, in order to attract private equity investment, the company should focus on cultivating a good management team, improve the corporate system, especially the board of directors’ system, and after the acquisition of private equity financing, the company should actively use the management experience, resource advantages and brand effect of private equity to broaden investment channels and promote its own development.

In practice, mature companies are the most attractive type of company, and PE companies tend to focus on established industries rather than new or more speculative ones for LBOs [5].

3. The Inequities and Disadvantages of Private Equity & Leveraged Buyouts

3.1. Shareholder’s Benefit Got Harmed

On the one hand, the LBO as an abuse of managements inside position and a gross violation of their fiduciary duty to shareholders [6]. Public shareholders can be cheated because stock traders outside the company's management can never know the optimum worth of the corporation's assets when put to their most economical use, while the managers who buy out their shareholders can make full use of the inside information they have.

If insiders believe that there is a significant difference between the current stock price and the price they can obtain through dissolution, liquidation, or redeployment of assets, they will repurchase the company from shareholders and "privatize" it. In fact, the offered price is more than stock market price, and company’s shares are again sold to the public soon after the insiders have bought them out, which suggests that the public shareholders did not get full value.

In this circumstance, managers who buy out their shareholders are guilty of purchasing stock on inside information, but stock traders outside the company's management can never know the optimum worth of the corporation's assets when put to their most economical use. Based on differences in information, any premium that management offers over the market price.

One presumes managers have not disclosed all their knowledge and insights about the company. They can also be charged with self-dealing by making policy principally for their own benefit and with disloyally usurping corporate opportunities that rightfully belong to all shareholders. Commentators have also questioned the harmful effects of these buyouts on the firm's prior creditors, some have thus argued that all such transactions are fraudulent conveyances, and the LBO unfair to a company's public shareholders.

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3.2. Social Instability

A study has shown that private equity funds had a significant role in leveraged buyouts of large US public companies between 1980 and 2006. The study shows that companies experienced a sharp decline in investment and growth when they are controlled by PE funds [7]. On the one hand, because of its inefficiency, the market does not favor long-term investments projects, and companies that undertake long-term projects are undervalued and then targeted for takeovers [8]. Under the combined influence of takeover pressure and the fear of being acquired at an undervalued price, managers focus more on short-term profits than on long-term goals. More importantly, the investment philosophy is influenced by the leveraged capital structure, which is the reason why managers decide to invest less.

Another study also reflects changes in capital structure and an increase in bankruptcy probability, causing companies to fall into financial difficulties. This study lasted for ten years and researchers studied the transactions of 484 leveraged buyout companies. They found that these transactions increased the company's bankruptcy probability by 18%.

4. Conclusion

4.1. High Efficiency at All

Despite the drawbacks of private equity and leveraged buyouts, overall, they have largely improved the efficiency of investments.

First, private equity helps to lowering investor transaction costs while boosting investment effectiveness. Private equity funds, a type of pooled investment, enabling investors to share economies of size and breadth while allowing a large number of investors to split transaction expenses [9]. Unlike direct investment, investors can benefit from transaction cost sharing mechanisms through private equity investments, improving investment efficiency.

Secondly, private equity is helpful in addressing the issues of moral hazard and adverse selection brought on by knowledge asymmetry. Firstly, private equity fund managers are often constituted of leading figures from business and finance that have extensive knowledge and experience in certain sectors as well as excellent analytical and comprehension abilities in challenging and risky business situations [10]. Senior executives, as general partners, will participate in the management of the business as shareholders after signing the investment project agreement, controlling and supporting the development of the investee company. As a result, shareholders of a private equity firm are in a better position than shareholders of other general companies to understand precisely the strengths and potential pitfalls of the business and to provide a range of management and advisory services to maximise the value added and share the benefits.

Thirdly, Private equity has the ability to contribute value and benefit from risk management. Investment portfolios, according to contemporary financial economics, can lower the unsystematic risks associated with economic operations, making them a crucial tool for risk management. However, for an individual investor, diversification can impose additional costs on the investor. As an illustration, the investor could need to minimize the amount of its investment in a particular business, thus giving the investor less control over that business, or the investor will have to expend more effort and cost in monitoring and managing the different investments. On the other hand, private equity reduces risk through aggregation, so for investors, fund investment can not only enjoy benefits but also increase the value of investment products.

The benefits of private equity investments are mainly in solving the three problems mentioned above. Even putting aside, the advantage of high returns, private equity investments are still very much an investment advantage compared to other forms of investment.

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4.2. Solution of Unfairness: Government Plays an Indispensable Role in PE & LBOs

The government should play an essential role in regulating the capital markets, using macro policies and restrictions to strengthen the control of private equity through administrative means. At the same time, legislation should be promoted to regulate capital market behaviour through legal means to effectively reduce social instability.

In terms of policy, the government should focus on creating a favorable institutional environment for the development of private equity, promote the construction of relevant laws and regulations, pay attention to the training of private equity talents, and improve the exit mechanism of private equity to escort the development of private equity in the country.

Firstly, the government has created a legislative framework for the growth of the private equity business, thus the investor could need to cut the percentage of its stake, for instance. The establishment of procedures and legal rules by the government is necessary for the growth of the private equity sector. Effective laws and regulations may control how investments are made, safeguard investors' interests, and lower the legal risks associated with investing. From the perspective of countries where private equity investment is more mature, none of them have enacted legislation specifically for private equity, but generally set up special chapters in the securities law, securities exchange law, fund law and additional laws should set explicit and detailed rules for the creation, administration, and information disclosure of private equity funds. For example, the Securities Act promulgated in 1933, the Securities Investment Act promulgated in 1934, the Investment Company Act and the Investment Advisers Act promulgated in 1940, the Japanese Small Business Investment Act promulgated in 1963, the Investment Business Limited Liability Portfolio Act promulgated in 1998, the Law for the Promotion of Technology Transfer to Universities and Other Institutions, the Law for the Promotion of New Business Creation and other laws, from These laws regulate PE investment in terms of how PE funds are established, the registration of private equity fund managers, the requirements for private equity fund exemption from registration.

Secondly, the government has given fiscal support and preferential treatment to investment. Indeed, one of the initiatives that many countries usually give fiscal support to investment is to conduct government procurement for the products of enterprises invested by private equity funds, and to offer loan guarantees and low-interest loans. In Europe and the United States, there is a comprehensive government procurement system, which can increase the market demand for the products of the invested enterprises, hence helping the growth of PE investment indirectly. In the United States, for every US$1 invested by a small business investment company, the government can provide a low-interest loan of US$4. At the same time, the government's Small Business Administration provides guarantees for bank loans to high-tech SMEs. The UK government has had a loan guarantee scheme for private equity investments since the 1980s.

Another initiative is to provide tax incentives for capital gains. For example, the US government reduced the capital income tax rate for PE investments from 49%-28% in 1978 and to 20% in 1982, while 60% of the income from PE investments was tax-free and the remainder was taxed at 50%. This initiative was significant for the growth of a number of high-tech companies. The UK Government passed the Venture Capital Trusts Act in 1995, which excludes tax on dividends and the sale of shares in venture capital trusts and provides a personal income tax credit of 20% of the investment amount for those who have held shares in a venture capital trust for more than five years. The Trust Investment Act provides that private equity funds that invest 80% of their entire capital in high-tech enterprises are eligible for a tax exemption to encourage investment in high-tech industries.

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Thirdly, for PE investment, the government must provide a favorable capital market environment. If the exit mechanism is not smooth, it will affect the profitability of private equity funds and will not ensure their liquidity and development. Therefore, the essence of private equity investing is exit, and the success and growth of private equity funds depend critically on how well the exit mechanism works. The capital market is the first choice for the exit of private equity funds, and the degree of development of the capital market determines the degree of development of the PE fund market. Globally, developed nations have largely maintained stable capital markets. For example, the capital market in the US consists of several levels, the fourth of which is the PE market. The UK's second board is a high-growth market, and a lower threshold unlisted securities market, the third board, can lessen the risk of private equity investment and guarantee the timely withdrawal of private equity. In Japan, the Tokyo Stock Exchange has established the GEM market, Osaka has established the NASDAQ Japan market, and local securities markets have opened up new markets for venture and growth companies. The multi-layered capital markets provide multiple channels for the exit of PE investments and facilitate the timely sale of private equity investors' control over various types of companies on the corresponding exchange markets for the next investment.

Fourth, the government's multi-channel participation in private equity investment. Many governments participate in private equity investment in various forms, one form is the government directly established industrial investment firms, venture capital funds, and guidance funds. Through this form, firstly, it can entice private money to the market and direct the development of the market. Secondly, it can effectively enable the government's industrial development policies to be implemented. This is the form of small business investment company established by the US government in the early stage of PE development. In Japan, government set up three government-run SME venture capital companies in Tokyo, Osaka and Nagoya in the early phases of growth of the PE market, as a guide fund to direct private capital to the market. Another form is to establish a fund portfolio, and it has the advantages of secondary risk diversification, professional asset management, simple investment decisions and a fund of funds is created when a certain amount of money is invested in several separate funds, each of which is itself a portfolio of investments. For instance, the government of New Zealand established a fund of funds for a corporation that manages venture capital funds, the United States government Asian private equity fund bidding professional investment fund management company, have achieved good results.

Fifth, government regulation of the private equity market and risk prevention. In the US, for example, the US government regulates the private equity industry relatively loosely, relying mainly on the American Venture Capital Association (AVCA). in 1996, the AVCA issued the "AVCA Transaction Standards" and regulates its members accordingly. The US government has recognized the need for tighter regulation of the PE business since the financial crisis and has sponsored different proposals on financial regulatory reform. In Japan, the regulation of the PE business is crucially influenced by government, with the Securities Bureau under the Ministry of Finance exercising regulatory authority over the Securities Investment Trust Act, which serves as the primary regulatory law, and the PE sector, private equity business, are all heavily regulated by the government. In the UK, the PE industry is regulated by the Financial Services Authority (FSA) and the Private Equity Association (PEA), a self-regulatory body.

4.3. General View

In general, the booming economy creates favorable conditions for the growth of the private equity market, and the efficient operation of the capital market does the same. The government also actively participates in promoting and facilitating the growth of the PE market, and it even takes on a direct role as the protagonist of PE investment. Contrasting PE investment's benefits and drawbacks with current business methods and roles of governments in the process of market

development, governments should improve the laws and regulations related to private equity, actively play a leading and binding role in the law, especially in coordinating relevant stakeholders and building a unified market system with multiple levels and non-segmentation.

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