Essays on top management and corporate behavior

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Chapter 1

Introduction

Human behavior is fascinating, and there is no exception to what its influences are on the financial market. This dissertation consists of three essays that examine corporate behavior that is affected by decisions made by the top management. More specifically, I study the considerations involved in the decisions to syndicate leveraged buyout deals (Chapter 2), to backdate or otherwise manipulate top executive stock option grants (Chapter 3), along with the design of top executive compensation with regard to family ownership (Chapter 4). In addition, I relate those decisions to firm performance, which might in return help verify the rationale behind the decision making process.

On the surface, these topics seem unrelated. Nevertheless, these decisions which influence performance all involve the top management in the corporations, i.e. senior managers in private equity firms (Chapter 2), and chief executive officers in public firms (Chapter 3) as well as in small public firms (Chapter 4). Therefore, this dissertation aims to contribute to the understanding not only the role played by the top management, but also the mechanisms involved in the process, either in decision making or in performance.

1.1 Private Equity

Private equity is refered to the pool of money invested in firms that are not publicly traded on a stock exchange or invested as part of buyouts of publicly traded firms to make them privately owned. The origin of modern private equity[1] in the U.S. can be traced back to the

[1] Hereafter private equity refers to (leveraged) buyout investments, not including venture capital, real estate, and any other asset class at times regarded as private equity as well. In this dissertation, I would

1950s. The first wave of leveraged buyout (LBO) boom comes in the 1980s, and since then it has become an important phenomenon in the financial market. Due to the junk bond market crash in the late 1980s, many LBO firms go bankcrupt, and the LBO activities almost come to a halt during the 1990s. It is not until the mid-2000s that we observe a second wave of boom which peaks in the middle of 2007.

The typical LBO firms are organized as a partnership or limited liability corporation. They are managed by General Partners (GPs), who make large acquisitions without committing all the capital required for the acquisition, mostly involving significant amount of outside debt financing[2] for the purpose of tax benefits, among others. In a typical LBO transaction, the private equity firm buys majority control of existing or mature firms, usually in constrast with young and emerging companies targeted by venture capital firms. Their investment funds have a roughly 10 to 14 years' life cycle. Usually, a new fund is initiated every 2 to 4 years, and there can be multiple funds simultaneously run by these firms. They raise funds from Limited Partners (LPs), mostly institutional investors nowadays, who are not allowed to add or withdraw their capital during the funds' life. There are three main channels (exits) that LBO firms realize their returns: an initial public offering (IPO), a merger or acquisition[3], and a recapitalization.

Among other proponents of leveraged buyouts, Jensen (1989) argues that private equity firms apply financial, governance, and operational engineering to their portfolio companies. Combining these three sets of changes improves firm operations and results in economic value creation. More specifically, compared with a typical public corporation with dispersed shareholders, low leverage, and weak corporate governance, private equity firm adopts highly leveraged capital structures, concentrated ownership, high-powered incentive managerial compensation, active governance, and a lean, efficient organization with minimal overhead costs. He thus predicts that this leveraged buyout organization would eventually become the

use the terms private equity and leveraged buyout interchangeably.

[2] Historically, the debt portion of an LBO transaction ranges from 60%-90% of the purchase price (Kaplan and Stromberg, 2009) .

[3] It includes: sold to strategic buyer, secondary buyout, sold to LBO-backed firm, and sold to management.

dominant form of corporations. Some critics dismiss this view and argue that value creation comes from tax breaks, superior information, and market timing (mispricing), without any real operational improvement.

Syndicated deals are common in the private equity industry. However, unlike the extensive study of venture capital syndication or loan syndication, the literature on leveraged buyout syndication is scarce. To fill the gap, in Chapter 2 ("Leveraged Buyout Syndication"), I use a sample of 947 LBO transactions mostly in the U.S. and Europe between 1991 and 2005 to study the considerations involved when senior managers in the private equity industry choose to syndicate the deals or not; and if yes, whom do they select to syndicate the deals with? Furthermore, I examine how the deal performance is driven by these two decisions, which helps verify the rationale for syndication in the first place. In short, I aim to examine the determinants as well as the consequences of leveraged buyout syndication. Moreover, since the decisions are made by the management team, my analysis focuses on the perspectives of the managers. In particular, I test whether their educational backgrounds might influence the decision to syndicate and whether there exists a networking effect when it comes to the selection of syndication partners.

1.2 Executive Stock Option Compensation

Since the 1980s, facing promising prospects but with financial constraints, firms have started to grant stock options to employees, especially in the high-technology industry. Stock options offer the recipients a right to buy company stock at a set price and usually have a vesting period of several years. These options are usually granted by directors and detailed by a compensation committee. In most cases, companies make their grants at the same time each year, avoiding the potential for date manipulation, but in fact no law requires this.

Apart from compensation, option grants aim to provide incentives that align the interests between ownership and control, which is viewed as an effective way to alleviate the principal-agent problems (Jensen and Meckling, 1976). As time goes by, taking options as an indispensable part of compensation packages becomes a common practice across firms. Hall and Murphy (2002) estimate that in 1998 the median values of stock and options owned by S&P's industrial and financial CEOs (chief executive officers) are \$30 million and \$55 million, respectively. Besides, Core and Guay (1999) find that, between 1992 and 1996, stock options contribute approximately one-third to the value of the median CEO's equity portfolio and one-half of total equity incentives, i.e. the sensitivity of portfolio value to stock price.

In the face of academic studies and comprehensive press coverage suggesting the wide use of executive stock option backdating among firms, in Chapter 3 ("Backdating or Otherwise Manipulating CEO Stock Option Grants"), I investigate what factors might lead to this practice. In contrast with the option repricing mechanism and the managerial power view, my alternative hypothesis is that option backdating or otherwise grant date manipulation is simply one way to reward and/or retain outperforming managers. To test this hypothesis, I study the universe of the U.S. top executive stock option grants. More specifically, the sample comprises 6,836 stock option grants of the top executives in the S&P 1500 companies during the period of 1999-2007.

Following Heron and Lie (2009), I estimate the likelihood of option manipulation based on the assumption that, in the absence of manipulation, the abnormal stock returns during the month preceding and following the grant dates should be centered around zero. One of the contributions is that, this study makes it possible for regulators and/or shareholders to identify firms that are more tempted to this practice. As a robustness check, I use a sub-sample of 126 companies being under internal review or (in)formal federal investigations regarding accounting and tax issues, and study whether the rationale still holds for this sub-sample.

Chapter 4 ("Small Family Firm, Agency Costs, and CEO Performance Pay") explores whether the existence of family influences helps alleviate the traditional principal-agent problem in small corporations. The literature on family firm is comprehensive, in particular regarding the relationship between family ownership and firm performance. However, few studies discuss the mechanisms involved in corporate governance. This chapter aims to provide a potential link, i.e. the design or the structure of CEO compensation. To that end, I construct a sample of 168 small publicly-traded U.S. firms between 2001 and 2005. I first evaluate the agency costs and examine how the family influences might mitigate, if any, the costs by the design of CEO compensation.