Private Equity in the Netherlands: Value Creation, Redistribution and Excesses

Private equity in Nederland: een stakeholder-perspectief

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FOREWORD

The advantages and disadvantages of private equity as governance model and source of funding feature prominently in societal discussions. How should private equity be viewed? Does it play a valuable role in the economy? And what is its impact on the various stakeholders? Debates on this topic are often heated. The involvement of private equity sometimes goes hand in hand with painful reorganisations. At the same time, private equity is an example of engagement on the part of investors. No longer do they merely passively invest in a company, rather they actively invest, with direct lines to management and board, and often for periods of more than five years.

This report contains insights of an extensive study recently conducted by researchers from the University of Amsterdam for the Dutch Ministry of Finance into the role of private equity, specifically in the Netherlands (see Ligterink et al. 2017).

The study focusses on buyouts. These are takeovers of mature companies (or parts of companies) by investors financed with considerable leverage (debt). Together with venture capital, buyouts are the most important forms of private equity.

The picture that emerges is a nuanced one. Broadly speaking, private equity plays a positive role and is associated with value creation, but excesses may take place. The study's most important contribution, however, is to provide insights into the role that private equity plays. What are the real sources of value creation? What role does leverage play? What are the potential redistributive effects among stakeholders? And where do conflicts of interest arise that could lead to excesses?

Together with insights on the role of private equity in the Netherlands, a comprehensive picture emerges that will hopefully help foster a healthy public debate.

TABLE OF CONTENTS

1 INTRODUCTION[1]

Private equity continues to be in the news. Proponents emphasise the positive effects it can have. They refer to the advantages of private equity as an alternative source of financing, as vehicle that provides expertise and access to a network of industry experts, as a governance model that leads to better company performance, and to the added value of private equity as an asset class. Critics, on the other hand, argue that no value creation occurs, rather the return for private equity investors is just a redistribution of value at the expense of other stakeholders such as employees, creditors, suppliers and tax authorities. They also point to the dangers of an excessive use of debt financing and the higher insolvency risks this is thought to entail. They claim that as a consequence costs are passed on to society, for example, through lay-offs of employees following insolvency. Critics also point to the possibility of an excessive focus on the short term by private equity investors.

Private equity is risk-bearing capital invested by private equity funds into what is ultimately a non-listed company. The two most important forms are buyouts and venture capital. A buyout is a takeover of a mature company in which the private equity fund generally obtains a majority stake in exchange for injecting equity, primarily raised from institutional investors. The equity investment goes hand in hand with substantial debt financing. The ownership model of private equity is temporary; an exit is usually planned after four to seven years. In the case of venture capital, equity is invested into start-ups or emerging companies.

The Nederlandse Vereniging van Participatiemaatschappijen (NVP), the Dutch trade association for private equity and venture capital firms, reports that in 2015, 348 Dutch companies attracted a total of 3.3 billion euros from private equity funds, nearly 2 billion of which came from foreign private equity funds. Dutch private equity firms raised a record amount of 3.2 billion euros in 2015 for making new investments, of which 268 million consisted of venture capital.[2] NVP also reports that 1,400 companies in the Netherlands (employing around 380,000 people in total) have a private equity investor as a shareholder.

The focus of this study – like the public debate – is on buyouts. The research questions are:

- What are the advantages and disadvantages of this form of financing and ownership?
- What is the importance of private equity in the Dutch economy during the period 2007-2015? Does private equity contribute to economic growth? If so, how?
- What is the effect of private equity on the companies in which it has invested? What is the added value, and what effects does private equity have on the stakeholders in these companies,

[1] We thank Ludovic Phalippou and Kees Cools for their contributions to the original study underlying this report (Ligterink et al, 2017). We also would like to thank Maureen Wouters and Janelle Zoutkamp for outstanding research assistance, and Sidonie Rademaker and Lorena Zevedei for their redactional work.

[2] Source: NVP website: http://www.nvp.nl/pagina/ondernemend%20vermogen/.

including the tax authorities? How do these effects differ from those of other sources of financing?

The study analyses how private equity operates, how it can create value, and where excesses might occur. It also contains an empirical study into the effects of private equity in the Netherlands. The study builds upon previous research conducted by De Jong et al. (2007) and Boot and Cools (2007).

The structure is as follows: Chapter 2 describes how private equity works and how a return is made on the companies in which a private equity fund invests. Chapter 3 provides insights into how private equity can create value, not only for investors, but also for society as a whole, and discusses findings of existing international empirical studies. The impact of debt financing (leverage) on the return and compensation of private equity investors is discussed in chapter 4. The source of returns is not necessarily value creation, but could also be associated with redistribution of value from other stakeholders to the private equity investors. This is the subject of chapter 5. Chapter 6 traces the development of private equity and buyouts in the Netherlands, and provides the key insights from an empirical study of the effects of private equity investments in the Dutch market.[3] Chapter 7 concludes.

[3] All details about the study into the effects of private equity in the Netherlands can be found in Ligterink et al. (2017).

2 WHAT DOES PRIVATE EQUITY DO?

How does private equity work? A private equity firm creates an investment fund from which investments are made. The investment fund is 'filled' with an injection of capital by the private equity firm itself, acting as general partner.[4] Meanwhile, capital is also obtained from limited partners. These limited partners are institutional investors such as pension funds, but may also be wealthy private investors. Under the general partner's leadership, the fund invests in multiple buyouts of companies. Besides capital from the general and limited partners, a considerable amount of debt is used.

Financing with debt offers tax benefits as interest payments are partially deductible. Leverage also enhances the reward for accomplishing improvements in the business. The return on equity becomes (even more) sensitive to the target company's performance. As an illustration, financing a company valued at 100 with 90% debt implies an equity investment of 10. Increasing the company's value by 5 then gives a 50% increase in the value of the equity claim; i.e. it increases from 10 to 15.).

As such, providers of private equity have strong incentives to actually improve the performance of the companies in which they invest. Additionally, the high leverage ensures discipline and a strong sense of urgency. The high debt load is after all also subject to default risk. In chapter 4, we examine the importance of leverage in greater detail. Heavy use is also made of performance-linked compensation, both within the private equity investment fund and within the target company. This encourages engagement in the target company.

How does a private equity fund generate a return on its investment? The investment fund's return often comes from a combination of the following sources:

- Operational improvements: implementation of measures that make the company more efficient (for example, more efficient use of the means of production in the company, selection of a better management team, better management information systems, improvements in logistical planning, better-focussed R&D, etc.);
- Revised strategic focus: implementation of a new/improved strategy, including better use of growth opportunities and optimisation of the corporate scope (for example, a buy-and-build strategy[5], disposal of non-core activities, etc.);
- Governance structure enhancements: aligning the financial interests of the company's management more closely with those of the shareholder (for example, by making management a co-shareholder), increased supervision and oversight (via stronger incentives and more direct access to information for the shareholders, etc.), changes in the supervisory board (more expertise, more direct involvement, forging relevant networks), stronger incentives through optimisation of leverage (increasing pressure and incentives through more debt financing).

[4] The general partner's contribution to the fund's capital is often around 1%.
[5] With a buy-and-build strategy, the private equity firm grows the target company through mergers and takeovers.

- Financial engineering: optimal use of tax benefits (interest expenses may be partially deducted from corporate tax). Because of its specific expertise and experience, the private equity firm may better know how to organise the company's capital structure in such a way that it can be financed with a relatively high amount of debt without facing a corresponding increase in insolvency risk.
- Investment selection and market timing: if private equity investors are in a position to buy up undervalued companies and then subsequently resell them, they can generate returns for themselves. Arbitrage may result from a greater ability to predict developments on the market (market expertise), access to better information about the company, and/or superior deal-making capabilities (negotiation skills and better access to deals).

The most important conclusion from the points listed above is that a company's business affairs intensify the moment private equity enters the picture. Whether this is actually the same as value creation – and, if so, for whom – is the main topic of the chapter ahead.

3 PRIVATE EQUITY AND VALUE CREATION

Private equity is a temporary ownership and governance structure that creates a strong financial incentive for action. Its central focus is to achieve a return for the investors. Yet, how are these returns created? And how does private equity impact the insolvency risk of companies in which it is invested? To start with, we discuss the value-creation potential of private equity as a governance model. What can it do that other governance structures cannot? Then, we take a closer look at statistical problems in measuring the performance of private equity. Afterwards, we turn to insights from the international empirical literature on the performance of private equity, including the effect on insolvency risk.

3.1 A CLOSER LOOK AT THE POTENTIAL FOR VALUE CREATION

Private equity addresses an important concern related to public equity: how to discipline management. Private equity involves a small group of shareholders: the general partner(s) – often young, well-educated and active – with direct access to management and the latest information. This makes it easier to maintain a steady focus and strategy with optimal coordination between management and shareholders. Within listed companies, the distance between management and shareholders is often greater, and the dispersion of shareholdings can lead to so-called 'free-rider' problems. This refers to shareholders 'looking to one another' which begs the question who is keeping watch over management? Each individual shareholder would be happy if someone else would put in the effort, but if everyone assumes that someone else is doing it, ultimately nobody will.

The combination of maximal co-determination and minimal information asymmetry reduces the typical agency problems characteristic of public equity. Another feature of private equity is the very strong alignment of interests of shareholders (i.e. the private equity fund) and management through a compensation contract with powerful financial incentives, often including an obligation for management to buy shares in the company. Such an obligation ensures that management not only profits when things go well, but also faces consequences when things go badly. Normally, management cannot sell its investment before an exit takes place. This illiquidity eliminates, for example, the incentive for management to manipulate short-term results (see Kaplan and Strömberg 2009, p. 131). The horizon is the moment of exit, which lies a few years in the future. Private equity funds also have no qualms about replacing poorly performing management at an early stage (see Acharya et al., 2013).

Another aspect of private equity which contributes to higher returns is a possibly more remote and clinical view which could make reorganisations easier. Furthermore, private equity can help companies achieve a change in strategic focus by injecting funds, expertise and access to an external network. Private equity funds (i.e. the general partners) often seek the advice of external experts with specialised knowledge on various aspects of the company's activities.

This execution is often accompanied by a disposal of activities that are determined not to be part of the company's core business, as well as additional takeovers to strengthen the company's actual core activities. The corporate scope (and adjustments made to it) are a primary focus of private equity investors.

The picture sketched above indicates that private equity has an added value and thus can have advantages as a form of ownership compared with other ownership structures. This should be expressed in an improved operational performance and stronger growth in the companies financed by private equity compared with similar companies that are not financed with private equity. Additionally, this suggests that private equity investors can achieve higher risk-adjusted returns compared, for example, to public equity.[6]

Box 1: Statistical Problems in Quantification

What happens to the company after the buyout? What changes do occur? In empirical studies, the greatest problem is that it remains unknown what would have happened to the company if it had not been bought out by private equity. In other words, the so-called counterfactual is unknown. To approximate this counterfactual, researchers look for the most relevant benchmark for comparison. Sometimes they choose to compare with the sector, or a collection of companies from the same sector with similar characteristics to the target company. This can already lead to an initial problem of selection bias; companies financed by private equity are not randomly chosen, but may precisely be those with the greatest potential for improvement, opportunities for growth, etc. Furthermore, the company's management and shareholders must be open to private equity. That means, there may also be a selection bias here. Companies that are open to private equity are possibly different, even if adjustments are made for obvious differences. This makes it difficult to compare the two groups (companies financed by private equity versus those without private equity financing) or draw conclusions about the effects of private equity.

Another problem in empirical research on the effects of private equity is that many of the necessary data are not (fully) available, at least in public databases. This is especially the case for non-listed companies taken over by private equity. The lack of data for private companies creates also a potential problem in choosing the correct sample of comparable firms. Publicly listed companies are often chosen for this because of the availability of data. But these are often relatively large companies, whereas private equity investments are usually smaller in size. Therefore, it remains unclear whether the findings of these studies can be generalised to provide insights into the often smaller buyout companies.

[6] Due to leverage, private equity investors automatically achieve higher returns on average, but this goes hand-in-hand with greater risk. Higher risk-adjusted returns, that are not caused by undervaluation at the moment of investment, should be an indicator of the company's improved performance (unless these higher returns are caused by tax benefits associated with leverage).

3.2 RETURNS FOR PRIVATE EQUITY INVESTORS (LIMITED PARTNERS)

Empirical studies show that, historically speaking, the net return for the limited partners of private equity funds is higher than that of a diversified stock portfolio (a value-weighted stock market index). This is true even after the deduction of costs and (considerable) fees. However, the spread in returns is large, and, when adjusted for disadvantageous factors, such as reduced liquidity and higher risk compared to the benchmark, there appears to be essentially no outperformance for the limited partners.

The general partners charge substantial fees. Metrick and Yasuda (2010) estimate, based on a simulation, that the present value of these fees is approximately 17% of the committed capital.

It is important to emphasise that the higher return on private equity is based on an average. There is significant variation over time and among different funds. Selecting the right funds and fund managers appears to be very important. Not every institutional investor has equal access to private equity funds. Particularly large institutional investors with a strong reputation will be invited by the most successful private equity firms to participate in their funds. On top of that, these larger institutional investors may have the in-house expertise to select the right funds and know how to keep costs in check. A smaller, less professional pension fund will have greater difficulty achieving comparably high returns.

Yet, even if these high returns are actually achieved, this does not necessarily mean outperformance. It can be a compensation for extra risk. The risk profile of a private equity fund is different than that of a well-diversified stock portfolio. The fund often contains smaller companies with a relatively low market value compared to their book value, and lower-liquidity investments are also typical. If adjustments are made for these extra risk factors, various studies find that the higher return is largely eliminated (i.e., it is attributable to these factors). That means there is no such thing as a significant outperformance for limited partners: the extra return is a compensation for exposure to these factors.

3.3 OPERATING PERFORMANCE AND INSOLVENCY RISK

Based on existing international research, we can cautiously conclude that private equity has a positive effect, on average, on the operating performance and growth of companies in which it is invested. Most studies find that companies achieve a higher EBITDA margin and higher revenues on average. At the same time, recent studies conclude that these advantages have declined over time (see, for example, Guo, Hotchkiss and Song, 2011). Important disclaimers must be applied here. In the first place, it is unclear to what extent the positive effects are caused by the selection of underperforming companies. This would indicate a selection effect rather than an outright positive contribution of private equity. Secondly, takeovers and divestments of parts of companies (which often go together with private equity investments) can lead to the creation of entirely different companies that have little to do with the original benchmark.

Studies find that the return often consists of three primary components: operational improvements and growth; market timing and selection; and advantages of high leverage. Acharya et al. (2013) find that, in a sample of 395 European buyout transactions, operational improvements and growth account for 35% of the return, market timing and selection for 15%, and advantages of higher leverage for 50%.

Another important element of the performance of private equity is its influence on risk, particularly insolvency risk. International research on the United States shows that insolvency risk slightly rises due to the increased leverage under private equity. This rise is, however, limited. Research by Hotchkiss, Smith and Strömberg (2014) on the US is probably the most extensive study of the impact of private equity on insolvency risk. This study examines more than 2,000 companies from 1997 to 2007 and finds a 4.9% chance of insolvency among private equity supported companies compared to a 3.6% chance among companies without private equity support. European studies such as Tyková and Borell (2012), covering a sample of European private equity companies, and Wright et al. (2014), covering a group of companies in the United Kingdom, find no differences in the probabilities of insolvency. Furthermore, Harford and Kolasinski (2013) find that refinancing activities used to pay out dividends have no discernible impact on a private equity-backed company's chances of insolvency.

Consequently, studies show that the risk of insolvency in a company financed by private equity is hardly higher on average than that of similar companies without private equity backing.[7] This suggests that private equity funds are apparently capable of properly managing the high degree of leverage.[8] Private equity investors aim to decrease the leverage (through the cash flows generated by the portfolio company) to a lower level before they exit the company. As the median holding period is 4 years, the high leverage of the portfolio company is more pronounced in the early years.

Since the chances of insolvency are only slightly higher, the expected societal costs (lay-offs, value destruction during insolvency proceedings, etc.) are limited.

Additionally, private equity funds act as buyers of (parts of) bankrupt companies, potentially enabling bankruptcies to be resolved more efficiently. This makes it easier, for example, to keep viable parts of a bankrupt company afloat.[9] Private equity also plays a significant role in the takeover market by facilitating the transfer of companies through restructuring and rationalisation of operational activities. In the process, it creates liquidity in the takeover market in places where it would otherwise be less available.

[7] The studies are not unequivocal. Some studies find an increase, where others find no change in the chances of insolvency compared with a group of companies that are not financed by private equity.
[8] An alternative explanation is that low-covenant loan agreements give private equity players a strong position with regard to their creditors, who, in turn, are quicker to make concessions in case problems arise.
[9] Private equity could enable viable parts of companies to be salvaged from insolvency (Imtech, for example), or prevent insolvency through well-timed reorganisations.

4 THE IMPORTANCE OF LEVERAGE

We shall illustrate how financing with debt influences the expected return and risk of private equity investments, before turning to its impact on the general partner's compensation (the carried interest).

4.1 THE INFLUENCE OF LEVERAGE ON INVESTMENT RISKS AND RETURNS

The effect of leverage on returns can best be explained using a simulated example. Suppose the value of a company that a private equity fund seeks to acquire is 100. In the first scenario, this investment is 100% financed by the fund with equity; in the second scenario, 50% of the investment is financed with equity by the fund and the rest is external debt; and, in the third scenario, equity accounts only for 10% of the investment, with the remaining being external debt.[10] Suppose, the private equity fund succeeds in increasing the target company's value by 15% (i.e. the value becomes 115) through operational improvements or organic growth. What would be the return for the private equity fund in each of the three financing scenarios? Considering that the value increase goes to those who have provided equity (the private equity fund), the return on an investment consisting entirely (100%) of equity is 15%. In the scenario where 50% of the investment is made up of debt and the fund's own equity makes up the other 50%, the return rises to 30% (i.e. (15/50) x 100%); in the scenario where debt makes up 90% of the investment, the return on the fund's equity investment increases all the way to 150% (see Table 1).[11]

Table 1: Development of the Shareholder's Return in Case of Value Creation of 15

	Value Increase of 15		
	100% Equity	**50% Equity**	**10% Equity**
Company Value	100	100	100
Equity	100	50	10
Debt	0	50	90
Value Creation	15	15	15
Return as % of Equity Invested	**15%**	**30%**	**150%**

Additionally, it is important to emphasise that greater leverage also increases the spread (and, therefore, the risk) of the private equity investor's return. Suppose there are two possible scenarios: the

[10] We have chosen for rather extreme values of the financing ratios in order to clearly illustrate the effect of debt financing on the expected return on equity of the private equity fund.

[11] For the sake of simplicity, we abstract from the cost of debt in these examples. If this is put at 5%, and the (one-time) 15% value creation is achieved in a single year, this leads to a return on the fund's own investment of equity equal to 15%, 25% (i.e. [(15-2.5)/50] x 100%)) and 105% (i.e. [(15-4.5)/10] x 100%)), respectively.

value added is 15, or there is a decrease in value of 5. How is the return on the invested capital affected for the private equity fund in case of a decrease in value of 5? Assuming once again that the fund's equity accounts for 100%, 50% or 10% of the investment, then the return on equity is -5%, -10% and -50% respectively (see Table 2). In other words, the higher the leverage, the higher the positive returns, but also the lower the negative returns on the fund's equity. This applies generally for returns on investments in the financial markets. However, in the case of active private equity involvement, the returns are effort related, and are basically a reward (i.e. extra returns) for the restructuring or new growth strategies. And that reward can be boosted by leverage.[12]

Table 2: Effect of (Operational) Value Decrease of 5 on the Return on a Private-Capital Investment

	Value Decrease of 5		
	100% Equity	**50% Equity**	**10% Equity**
Company Value	100	100	100
Equity	100	50	10
Debt	0	50	90
Value Creation	-5	-5	-5
Return as % of Equity Invested	**-5%**	**-10%**	**-50%**

4.2 THE EFFECT OF LEVERAGE ON THE COMPENSATION OF THE GENERAL PARTNER

The general partner of the private equity fund is compensated in the form of a management fee and a fee related to the fund's performance (the carried interest). In this section, we demonstrate how the buyout, as a means of financing, influences the general partner's carried interest. Suppose the agreement contains apart from the 20% carried interest, a 'hurdle' of 8%. This means that the general partner only receives their carried interest once the limited partners achieve at least an 8% return on their investment. Once this 8% return is achieved, the general partner receives a follow-up return until it reaches a return of 20% (this is known as a catch up). Any additional return achieved is then distributed at a ratio of 80% (for the limited partners) to 20% (for the general partners). The total of this performance-based variable compensation for the general partner is known as the carried interest.

To illustrate the effect of leverage on the carried interest, we return to the example used in section 4.1. Assume a 20% carried interest on the return achieved above the 8% hurdle. Although, in

[12] Leverage thus increases the reward. Note that this is totally different from the focus of the famous work of Modigliani and Miller that looks at returns that investors require for holding stocks, bonds or other assets. Those returns do typically not reflect any skill or action, but are a compensation for time preference and risk. With leverage those returns need to be higher to compensate investors for extra risk.

reality, the carried interest is usually calculated based at the fund level, we will assume here for the sake of simplicity that only one investment has been made from the fund and that all value is created within a single year. We assume a total operational value creation within the company of 15 on top of a company value of 100. We will show the carried interest for the three scenarios, in which the fund's investment of equity amounts to 100%, 50% and 10%, respectively.[13]

In the first financing scenario, the fund's equity accounts for 100% of its investment. In that case, the limited partners first receive a return of 8% on their investment (i.e. 108). Then, the general partner receives an amount equal to 20% of the return paid out thus far. This is 25% of 8, which equals 2. The rest (15 – 8 – 2 = 5) is distributed among the general partner and limited partner according to the 20/80 rule. Therefore, the general partner receives an additional 0.2 x 5 = 1 from this. In total, the general partner receives a carried interest (performance-based compensation) of 3 in this scenario. If we carry out these calculations for each of the three financing scenarios, we will see that, in each case, the general partner receives 3 (see Table 3). This seems to suggest that the general partner is indifferent with regard to the financing proportion, but that is only the case if we look at a single investment. In fact, by financing with more debt, the general partner can finance more projects, considering the size of the investment fund, and thus increase their total compensation across all projects combined. Suppose the general partner's fund has a size of 100. In that case, the general partner can make a single investment in which equity amounts to 100. If the fund invests fully with 50% debt, it has 200 to invest (100 equity and 100 debt), thus enabling it to take on two projects of 100 each, and thus receiving twice the carried interest. If the fund invests with 90% debt, even 10 such projects can be taken on, each contributing to the general partner's carried interest. In other words, the total carried interest increases proportionally to an increase in leverage.[14] It is important to note that the carried interest is calculated based on the fund level so that, if one investment fails to deliver a good return, it comes at the expense of the total carried interest.

It then becomes clear that the general partner of the private equity fund has an interest in financing investments using debt to the greatest extent possible.

[13] For the sake of simplicity, we do not take management fees into consideration in this example.
[14] In the example in Table 3, we assume that the cash flow is high enough to pay out the hurdle as well as the catch up.

Table 3: Development of Carried Interest in a Project Under Various Financing Scenarios

	100% Equity	**50% Equity**	**10% Equity**
Company Value	100	100	100
Equity	*100*	*50*	*10*
Debt	0	50	90
Operational Value Creation	15	15	15
Value of Equity at Exit	*115*	*65*	*25*
Hurdle Rate (8%)	108	54	10.8
Surplus Profit Above Hurdle	7	11	14.2
GP's Catch up (up to 20%)	2	1	0.2
GP's Remaining Carried Interest	1	2	2.8
GP's Total Carried Interest	**3**	**3**	**3**

4.3 LEVERAGE AND VALUE CREATION

There are multiple reasons for using leverage in buyouts. It makes it possible to do 'more' with a limited amount of equity, thus increasing a fund's clout (multiple buyouts can be done by adding debt to the available funds). It enables more concentrated shareholdings (fewer additional shareholders needed) improving engagement and reducing free rider problems. Leverage increases the return on the private equity investors' efforts, and the performance-sensitivity of the general partner's compensation (the carried interest). It further could enforce greater discipline and urgency. Additionally, it could offer tax benefits as stated.

Private equity funds can raise the leverage even more by providing loans themselves (so called shareholder loans). The interest rate on these loans is usually high, and could further increase the tax savings. Depending on the selected structure, the private equity fund's interest income is either non-taxable or taxed at a relatively low rate.

The tax benefits associated with leverage have been scaled back by recent legislation in several jurisdictions. In 2012, the Netherlands began limiting the tax-deductibility of interest payments. In the tax plan for 2017, the deductibility of interest on shareholder loans was abolished through an amendment to Article 10a of the Dutch Corporate Tax Act.

The high degree of leverage is often seen as undesirable by critics because it reduces taxes for the government and might expose the company and its investors to a high level of insolvency risk. Critics also claim it can be used as a means of 'pillaging' a company by having it pay out a superdividend with the cash from newly issued debt. This may result in greater insolvency risks, and it may impact the company's future prospects.

However, general partners of private equity funds seem capable of properly managing the risks of greater leverage. They work closely with the company and contribute their own knowledge and expertise. This makes them better capable of promptly evaluating the desirability and necessity of additional injections of capital as soon as problems arise. They also often have a relatively strong negotiating position when dealing with creditors (e.g. banks). Additionally, they may care about their reputation because investors need to be found for new funds that they may establish in the future. This argument expands to creditors of the firm as well as management. Since private equity firms also want to fund future investments with relatively high debt levels, they have an additional incentive not to default on their debt. Management will prefer a private equity investor with a good track record as they often invest alongside the private equity investor and thus has "skin in the game".

5 REDISTRIBUTIONS AND POSSIBLE EXCESSES

Besides 'real' value creation, the return that private equity investors earn can point to a redistribution at the expense of other stakeholders. Employees may lose their jobs or face pressure to accept lower salaries, suppliers may be forced to make concessions, and creditors may be pressured to lower their claims. If private equity raises the company's risk profile, a heightened insolvency risk may inflict damage on other stakeholders.

In the section below, we first discuss possible negative aspects of private equity, specifically the often-bemoaned short-term focus and aggressive 'asset stripping' (selling a company's underlying assets following the buyout). Then, we turn to possible redistribution effects. We discuss redistribution effects towards the government (tax arbitrage), the possibility of favouritism towards management at the expense of existing ('old') shareholders, redistributions that put employees at a disadvantage, and redistributions between the general and limited partners. Finally, we examine the possible spillover effects of private equity on the sector in which the target firm operates, and externalities vis-à-vis the economy as a whole.

5.1 INVESTMENTS, SHORT-TERM BIAS AND ASSET STRIPPING

Does private equity lead to a heavier focus on the short term, in the sense of damaging the long-term prospects of the target company? The notion of a stronger short-term mentality among private equity companies (compared to similar non-private equity-funded companies) is only in a very limited way supported by findings in the international research. Studies on the effects of private equity in the 1980s found that private equity-financed companies invest less. This could be characterised as a stronger focus on the short term. However, at that time, private equity focussed primarily on inefficient conglomerates in need of restructuring. This would naturally lead to reductions in scope and limits on wasteful investments. To characterise this as an undue bias in favour of the short term is somewhat misleading. In recent decades, private equity is more focussed on growth, with typically no decrease in investments throughout their ownership. Recent studies show that the level of investments in R&D does not decrease under private equity but it does become more focussed. A median holding period of 4 years would also suggest a more medium term, rather than short-term focus.

Another (related) criticism focusses on 'asset stripping' and superdividends; basically, selling assets at the expense of future opportunities of the firm in order to increase profit distributions. However, asset stripping and the issuing of superdividends are not structural occurrences in companies taken over by private equity. Although superdividends have been observed in some cases, and may indicate that the company in question is being pillaged, research by Cohn, Mills and Towery (2014) finds that even for businesses in the 90th percentile of highest dividend payouts, dividend accounts for only 0.1% of the transaction value in the first year and 1.7% in the second year. This means dividends were

even lower than *before* the buyout. The study does find that companies (buyouts) with low cash flows tend to pay slightly higher dividends, and vice versa. However, the effect on the economy, as a whole, is very limited.

Furthermore, the possibilities of paying superdividends have been somewhat limited by government policy. Around the world, legislative measures have been enacted to prevent excessive profit distributions and 'asset stripping' in its purest form.[15] In the Netherlands, this falls under directors' liability (Article 2:216 of the Dutch Civil Code) and the AIFM directive, which is enshrined in law (Article 4:37v of the Dutch Financial Supervision Act (Wft)). Under Article 2:216 of the Dutch Civil Code, directors must act in the company's interest when carrying out planned profit distributions. They must test on the basis of realistic prognoses whether the distribution may result in continuity problems for the company. In the event of insolvency, the directors can be held personally liable if this testing was not carried out, or was carried out inadequately. If shareholders have received dividends and the company goes bankrupt, the creditors can claim and recover the wrongfully paid out amount from the shareholders. The AIFM directive (Article 30) contains a measure to counter asset stripping; among other things, it requires the private equity fund with a controlling interest in a company to abstain for the first 24 months from supporting actions that affect the assets of the company in question. This is intended to prevent a private equity fund from selling off valuable assets and redirecting the profits to themselves by paying dividends.

Another source of concern is that excessive leverage places too much pressure on management, tempting them to 'cut corners'. There is some evidence that high leverage pushes management to increase short-term cash flows in order to help deal with the debt burden. This could lead to a degradation in the quality of products. Matsa (2011) shows that this can indeed occur. He found that concessions were made with regard to the quality of products in heavily debt financed private equity transactions in the American supermarket sector. This does seem to indicate a short-term focus: in the longer term, a similar strategy would probably cost the company clientele and revenue. This research is, however, too limited to draw broader conclusions.

Overall one could say that there is no reason to assume that desirable investments decline. R&D investments are, however, more focussed under private equity.[16] Only in isolated cases are superdividends paid out at an early stage. However, absolute conclusions cannot be drawn. Concerns can be raised about limitations in the empirical studies, including selection biases. Also, as mentioned previously, research focusses primarily on relatively large companies because more data on these companies are publicly available.[17]

[15] 'The purest form' refers to selling assets so that superdividends can then be paid out, leaving creditors and employees with a 'hollowed-out' company.
[16] Lerner et al. (2011) argues that patents of LBO firms seem to have a higher economic impact as they are more cited.
[17] The study by Cohn et al. (2014) is an exception. Cohn et al. base their research on tax returns, thus incorporating data from smaller, more comparable companies.

5.2 MARKET TIMING AND SELECTION

An alternative (partial) explanation for the positive return for private equity investors is the possibility of timing as well as selection. If a private equity fund is good at selecting undervalued companies that it later sells for a higher price, this is 'merely' a transfer of value from the shareholders of the target company to those of the private equity fund. In that case, the returns reflect the elimination of undervaluation, rather than value creation. This can also apply to the buyout of a company with undervalued assets which are then sold off in parts (asset stripping).

Exposing the undervaluation can actually have real effects. Achieving an accurate valuation can enable assets to be allocated more optimally. It sends a better signal about where opportunities are, and thus can result in a better allocation of resources.

Strategies focussing on market timing and asset stripping were particularly popular in the 1980s when breaking up conglomerates was common. In those cases, not only was undervaluation an issue, but typically also underperformance of the different parts. Within the conglomerate, the different pieces could hide their shortcomings. Breaking up these conglomerates allowed a more focused response offering possibilities for real value creation.

5.3 REDISTRIBUTION EFFECTS

In this section, we discuss how private equity can lead to redistributions of value among the various stakeholders and private equity investors.

Government and Tax Arbitrage

Private equity goes hand in hand with a relatively high level of debt. This produces tax savings through the deductibility of interest payments. As a result, the government loses out on tax revenues. This has led many countries to develop regulations to limit tax deductions for leveraged buyouts. In Germany, for example, the deduction is capped at 30% of EBITDA. The Netherlands has set limits on the interest deduction with its 'acquisition holdings' decision of 2012. Article 15Ad of the Dutch Corporate Tax Act of 1969 specifies that, effective 1 January 2012, only the interest on the healthy part of the acquisition debt is deductible. The healthy part is set at 60% of the acquisition price. This is lowered by five percentage points each year, for a period of seven years after the buyout, until it reaches 25%. The deduction limit includes a SME franchise of 1 million euro interest per year.[18]

Tax arbitrage can also take place by charging management fees at the company level. These management fees are (partially) tax-deductible. Depending on where management fees fall, they may be taxed at a lower rate, or not at all.

[18] For further analysis of the fiscal aspects of private equity, see Van de Streek (2015). With the recent Dutch Tax Plan of 2017, interest deduction for shareholder loans has been abolished.

The tax advantages of leverage are significant. Knauer et al. (2014) find that tax savings in Germany, for example, amount to between 16% and 20% of company value. This results in lower tax revenues for the government. The benefit comes with higher prices that are paid during a buyout and thus seem at least in part to be transferred to the bought-out shareholders of the companies being taken over (see Jenkinson and Stucke, 2011).

As indicated, tax benefits are by no means the only reason why private equity transactions involve leverage. They are simply part of a broader set of forces, including the impact of leverage on incentives. The (further) elimination of tax benefits will therefore not make the relatively high use of leverage in private equity disappear.

Redistribution Through Favouritism Towards Management

A less flattering example of private equity transactions is whenever the deal is consciously created to achieve more lucrative rewards at the expense of existing shareholders. In particular, management of the target company might be susceptible to pressure or promises from the private equity fund. Management may have been approached in the run-up to the buyout and, based on promises made with regard to its role in the buyout, already be acting in the interest of the private equity fund instead of in the interest of existing shareholders or other stakeholders.

Some evidence of this is found, for example, in the study by Mao and Renneboog (2015), which shows that, in management buyouts (MBOs), more downward earnings-manipulation takes place in the year leading up to the transaction. It may imply that existing management tries to negatively influence the value of the company in order to bring down the purchase price for the private equity fund. This creates a greater potential to increase the company's value after the transaction. Management might benefit if it is promised a role post-buyout, particularly when it gets shares. In any case, this calls for an active role on the part of non-executive directors (the supervisory board) of the target company; its management might be compromised. In Box 2 the (failed) buyout of Qantas by a consortium of private equity parties is discussed, illuminating some of these issues.

Box 2: Conflicts of Interest Between Shareholders and Management at Qantas[19]

In early 2007, a consortium of private equity funds (referred to here as APA, a group which included Macquarie and TPG) made a bid 33% above the latest share price on shares in the listed Australian airline company Qantas. In March of that year, Qantas released its annual report which showed earnings that were 30% to 40% higher than had been expected. APA did not increase its bid based on this information, and on 12 April, amended the bid so it would be conditional on backing from 70% of Qantas shareholders. Yet, by the 7th of May of that year, not even 50% of the shares were offered, prompting APA to withdraw its bid.

[19] This case study is based primarily on a study by the Melbourne Centre for Financial Studies (2009).

The most important reason why the buyout fell through was that investors considered the bid to be too low. However, in addition to that, a conflict of interest between management/board and shareholders may have played a significant role.

Qantas chairwoman Margareth Jackson had been a strong proponent of the deal. The fact that no increase in the bid was requested despite the company's reported earnings being higher than expected, contributed to the perception that management at Qantas was eager to make a deal that played into the private equity fund's hand rather than putting the interests of the ('old') shareholders first. Qantas announced that its management would acquire 1% of shares in the privatised company (a value of around 110 million dollars). Later, it was revealed that this stake might increase to as much as 4.5%. These revelations reduced confidence in both management and board, and ultimately contributed to the shareholders' decision to turn against them. The Qantas case raised much attention and concern in Australia and other countries over conflicts of interests in private equity buyouts.

There are several other ways in which management might be compromised, for example, exorbitant severance packages might be offered for members of management who consent to the buyout. Again, this would tempt existing management to advise shareholders to sell the company too quickly and at a price that is too low.[20] This puts existing shareholders at a disadvantage, and calls for a vigilant role of non-executive directors.

Redistribution and Employees

The impact of private equity on the size of the workforce within a company is, on average, negative during the first year after the buyout; however, the workforce generally recovers in the years after that (see Cressy, Munari and Malipiero, 2007; Wilson et al., 2012; Boucly, Sraer and Thesmar, 2011). In private equity transactions focussed on restructuring, a more permanent negative impact of private equity on the number of employees can be expected. However, also here, understanding the counterfactual is important: what would the prospects of employees have been if the restructuring would not have taken place?

Also, Schumpeter's 'creative destruction' argument should be taken into account. What opportunities come about by restructuring or downsizing a bloated incumbent, or by enforcing a strategic reorientation? The company itself might ultimately grow again based on the strategic reorientation (with possible subsequent mergers and takeovers by the company).[21] The most extensive study of the effects of private equity financing on employment in companies is Davis et al. (2014). That study analyses a very broad dataset from 3,200 buyout companies during the period 1980-2005, concluding that buyouts lead

[20] This conflict of interest also may occur in non-private equity initiated takeovers (see for example Mannesmann, where management received a very favourable retirement package).

[21] Note that the process of shrinking and growing again will not be without pain, nor without costs to society. Whenever a mass outpouring of older workers occurs, they may not be able to re-enter, and substantial costs are passed on to society even in the long(er) term.

to a limited *net* loss of jobs (less than 1%) but result in significant *gross* job creation. While a considerable number of jobs are eliminated, a large number of new jobs are created (resulting in only minor net job losses).

With regard to salaries per employee, the picture is less clear. Some international studies find a slight decrease, while others identify an average increase. Although identifying the exact reasons for such ambiguous findings remains anyone's guess to a certain extent, there are two effects which seem to play a part. Private equity exerts downward pressure on salary levels in general, but, at the same time, there is a possible shift towards more higher-level job positions.[22] Studies show that other forces and arrangements that surround employees (union membership, occupational safety records, career perspectives, complaints procedures, internal promotions, etc.) do not fundamentally change.[23] In that sense, there seems to be no systematic evidence of indirect transfers of value from employees to investors.

Redistribution from Limited Partners to General Partners

The general partner's compensation contract (with management fee and carried interest) should seek to align the interests of the general partner with those of the limited partners. Nonetheless, conflicts of interest may still arise. These are primarily related to the fact that the general partners place great importance in the size of the fund (see also our analysis of the carried interest), whereas limited partners are primarily concerned with the return on their investments. The urge to see the volume of the fund (and that of subsequent funds) as objective can lead the general partner to undertake less optimal investments, particularly at the end of a fund's lifetime. The general partner's reputation and strong screening measures by the limited partners of private equity funds are intended to keep this behaviour under control. Furthermore, the general partner can charge all kinds of other fees, for example, a management fee to be paid by the company. Nowadays, limited partners usually try to define such fees in their contracts with the fund or negotiate that these fees will be deducted from the amount of carried interest paid to the private equity investor. Nonetheless, transparency towards smaller investors in particular remains a concern. Market forces could prompt some discipline. Currently, however, a relative surplus of capital has given rise to a 'demander's market', giving general partners greater power, and putting market discipline under pressure.

5.4 SPILLOVER EFFECTS OF PRIVATE EQUITY

Two recent studies (see Bernstein et al., 2010; and Lubbers, Von Eije and Westerman, 2015) have examined the impact of private equity on the meso- (i.e. sectoral) level. Bernstein et al. (2010) find that sectors in which private equity funds have been active in the last five years experienced relatively more growth in employment as well as more investment. This may point to spillover effects onto competitors

[22] A possible mechanism for this is that financing with large amounts of debt, and the resulting pressure on the company, does weaken the negotiating position of employees; for a thorough theoretical discussion of this topic, see Perotti and Spier (1993).
[23] See, for example, the survey by EVCA/CMBOR (2008).

in the sector due to the presence of private equity funds. For example, if private equity involvement via, 'creative destruction' elevates competition, that competition could stimulate non-private equity-financed companies to increase their productivity and improve operational processes.

It is too soon to draw strong conclusions based on these studies. They are simply too sporadic for that. It is clear, however, that there is a real possibility that the presence of private equity financing has positive effects on other companies in the same sector. Research on this topic is still in the early stages.

6 DEVELOPMENTS IN THE PRIVATE EQUITY MARKET IN THE NETHERLANDS

The market for private equity investments reached its high point in 2007, both worldwide as well as in the Netherlands. Aside from the overheating at that point and the correction that followed during the financial crisis (especially in 2009), the volume of private equity increased steadily over the last three decades. However, the market develops in waves which are strongly influenced by the degree to which debt is available at any given time, as well as how easy it is to make an exit. The latter depends strongly on the stock market.

In this section, we first provide general information about the Dutch private equity market. Subsequently, we present empirical insights from an analysis of buyouts in the Netherlands during the period 2007-2015.

6.1 PRIVATE EQUITY IN THE NETHERLANDS

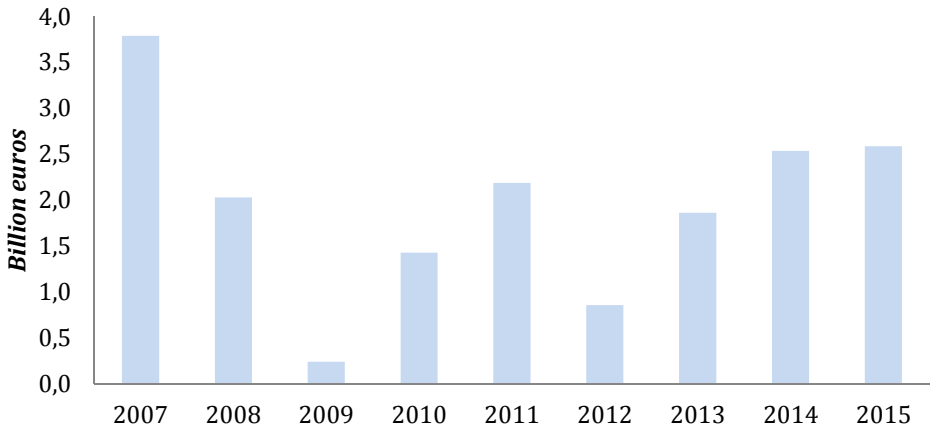
Because of relatively high returns in the past – at least compared with a well-diversified equity index – private equity has become a popular asset class for institutional investors. The pension fund ABP, for example, has invested approximately 5% of its total portfolio in private equity since 2005. The increasing supply of capital for private equity is also a result of the relatively high number of exits by earlier private equity funds, which frees up capital for reinvestment. As a consequence, there are currently many funds on the market with relatively high amounts of capital that is committed but not yet invested (also known as 'dry powder'). In such a market the suppliers of capital may have a relatively weak bargaining position compared to the demand side (i.e. the private equity funds).

Annual private equity investments in the Netherlands from 2007 to 2015 amounted to between 0.14% and 0.75% of GDP (see Figure 1).[24]

The greatest portion (62%) of private equity investments falls in the category mid-market, with an investment of between 15 and 150 million euros in equity; 22% are smaller deals, and the remaining 15% are large transactions (see Figure 2). For the period from 2007 to 2015, 46% of the total investment volume on average was initiated by foreign private equity firms. Syndication, in which multiple private equity parties are involved, occurs regularly (29% of the time on average for the 2007-2015 period).

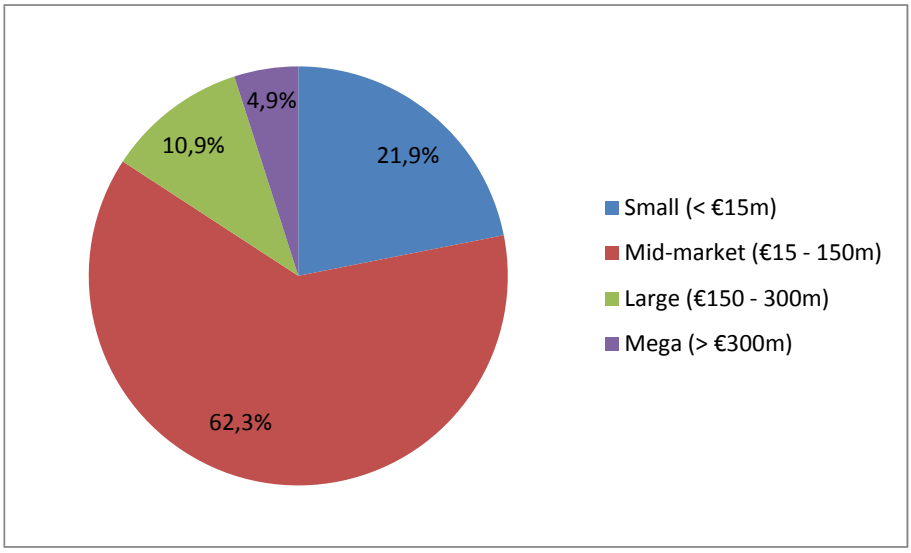
[24] Because of the relatively high degree of debt financing, the clout of private equity is greater than its own contribution of capital (including any shareholder loans). This is reflected in the higher leverage, on average, after a buyout. Following the crisis, around 60% of the capital in private equity-held companies is debt, which is somewhat below the average amount of debt before the crisis. This refers to the all-in leverage (i.e., the leverage on the level of the buyout holding as well as within the company).

Figure 1: Overview of the Development of Buyout Investments in the Netherlands by Private Equity Funds (European PE Funds); in Billions of Euros



Source: Invest Europe country tables 2007-2015 (Table 26)

Figure 2: Classification by Size of Financing in Buyouts by Private Equity Funds; Averages (2007-2015)

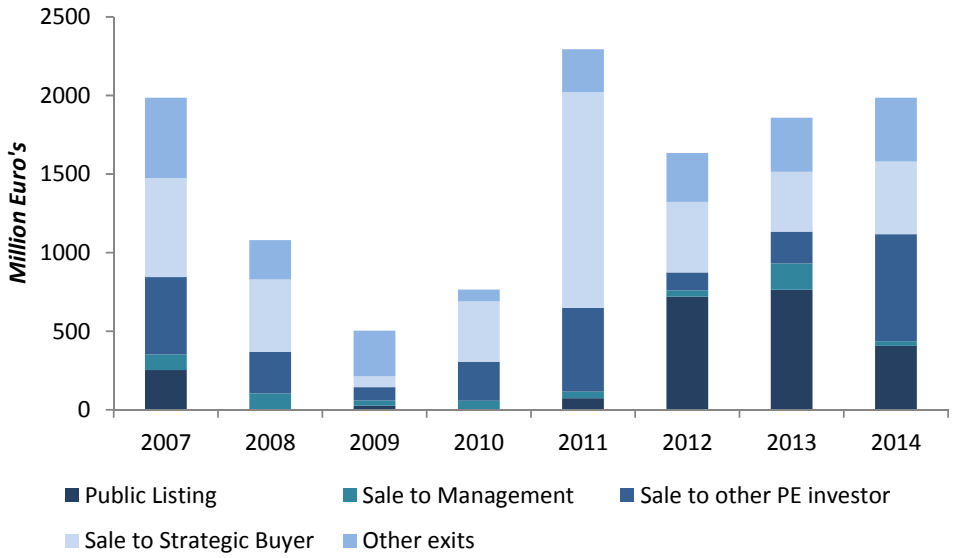


Source: Invest Europe country tables 2007-2015

Private equity funds maintain their investment for approximately five years on average. For the period from 2007 to 2015, selling to a strategic party (an operating company) was the most commonly used method of disposing of a company (33% of all cases). Reselling to another private equity fund

(secondary buyouts) accounted for 20% of sales, while 12% of cases ended with an exit through a public listing. Secondary buyouts are becoming increasingly important, not only in the Netherlands, but worldwide. The increase in secondary buyouts is explained in part by private equity funds that still need to invest despite reaching the end of their investment period (usually the first five years of a fund), or by funds that need to get rid of their investments at the end of the fund's lifetime. Secondary buyouts can also be optimal from a value-creation point of view when successive buyouts build on complementary skills; for example, through a restructuring in the first round towards a growth strategy afterwards.

Figure 3: Divestments (Exits) by Private Equity in the Netherlands (2007-2015) Organised by Exit-Type; in Millions of Euros



Source: Invest Europe country tables 2007-2015, Table 37

6.2 INSIGHTS FROM EMPIRICAL DATA

Although governance models vary from one country to the next, the ultimate manifestation is far more uniform than it seems (see Boot, 2010). This is even more so for the private equity model. Private equity as a governance model has very few fundamental differences across the world. Dutch funds invest in the Netherlands and abroad, and the same goes for their fundraising. There are also many foreign private equity funds active in the Netherlands. As a result, the insights from the international empirical studies mentioned in Chapter 3 are undoubtedly also relevant for the Netherlands.

In addition to taking stock of these insights, we have specifically look at the Netherlands (see Ligterink et al., 2017, for details). Based on two complementary samples, an attempt is made to gain

insights into the effects of private equity buyouts in the Netherlands. The first sample is based on a public database (Zephyr by Bureau van Dijk, referred to here as BvD). Based on this, 595 private equity buyouts were identified for the period from 2007 to 2015. The results of these buyouts are compared with two control groups. One control group contains ten Dutch companies which are comparable in size and sector, and the other consists of ten similarly comparable European companies. Based on this, we examine the development of certain figures from one year before the buyout until three years afterwards, or the moment of exit. Because the availability of data for these companies is often limited, the final sample is considerably smaller and the number of companies varies depending on the aspect being examined. As such, less than 5% of the original sample remains for certain figures related to revenue, debt, number of employees, and taxes. This may impact how representative the ultimate sample is, implying that the results should be interpreted with caution.

The second, much smaller sample (31 buyouts) contains more detailed information, making further analyses possible. We refer to this database as the PE database (alongside the aforementioned BvD database). The PE database contains information on the size of the investments and the characteristics of the companies involved, specifically for the year in which the buyout occurred until the exit (in so far as the exit has already taken place). The most important insights are discussed below.

Holding Period and Deal Characteristics

The median holding period for both samples is four years for the companies that realised an exit during the period 2007-2016. This is comparable to the European median. Furthermore, only 192 of the 595 companies had realised an exit. This is most likely related to the influence of the crisis. This means that the actual period a company is held by private equity on average is longer.

In most cases, private equity funds buy a majority stake (90.3% in the PE database). In 16% of cases, co-investors are involved – investors who invest along with the private equity fund – and in nearly 10% of cases, multiple private equity funds participate in a single deal. In terms of the initial investment, private equity funds buy from a strategic seller in 33% of cases; in 42% of cases, they buy from other private equity funds; and in 25% of cases, they buy directly from company owners or their families. When realising an exit, private equity funds choose a strategic buyer 33% of the time. Alternatively, they sell to a different private equity fund (39%), undertake an Initial Public Offering (IPO) (3%), or sell to a family, private investor or company management (3%). In 18% of cases, the company is written off.

Effect on the Company

The BvD database shows higher median growth of total assets and earnings for companies during the first three years under private equity, compared with the control groups. This suggests that private equity funds are capable of either selecting fast-growing companies, or speeding up the growth of the companies they invest in. It is important to repeat the aforementioned disclaimers for these findings as well. If the

positive effects are the result of selecting companies which had previously grown less rapidly, this would indicate (partially) a selection effect rather than a positive impact of private equity outright. Secondly, takeovers and disposals of parts of companies (which often go together with private equity investments) can lead to the creation of entirely different companies that have little more to do with the original benchmark. The importance of this fact can be seen, for example, in the BvD database, where 57% of the portfolio companies were involved in mergers and buyout activities in the period under private equity ownership.

Compared with the year before the buyout, private equity companies have more debt.[25] This decreases at the end of the lifetime for those companies that subsequently have had an exit. Other findings show how important it is to correct with a control group. For instance, the performance of the private equity companies shows a negative trend, but relative to the control groups it is positive. In other words, companies with private equity as an investor perform better. Furthermore, it appears that companies that have had an earlier exit are the 'problem children': their growth rate is negative compared with that of the control groups.[26]

The Employee's Perspective

In terms of the number of employees, we see an increase for the companies in the large BvD database from one year prior to three years after the buyout. The control groups, however, show an even stronger increase. The difference in employee growth rates between the private equity companies and the control group companies is not significant. Also for companies with an exit, the increase in the number of employees is not significantly different from that of the control groups. The number of observations here is, however, very limited.[27]

The cautious conclusion to be drawn from this is that private equity does in fact maintain employment levels, but ultimately shows less growth in employment numbers than the control groups when the full three-year period is taken into consideration. Combined with the aforementioned higher growth in total assets and earnings compared with the control groups, this means that private equity succeeds in growing companies without a corresponding growth in employment.

The Investor's Perspective

We only have information about the returns achieved by investors for the small PE database. The median return (IRR) amounts to 24% for all companies combined; for the companies with an exit, the IRR amounted to 22%. These returns are not adjusted for fees charged by the private equity fund.

[25] The amount of debt is probably still underestimated, considering that a portion of the debt often remains in the buyout holding, and this cannot be ascertained in the figures from the database.

[26] For the PE database, we see strong growth in earnings and an increasing company value. In addition to this, there is a slight decrease in EBITDA and debt compared with the year in which the buyout itself takes place (information for the year prior to the buyout is not available).

[27] In the small PE database, we also witness an increase in the number of workers measured three years after the buyout, or, alternatively, at the moment an earlier exit takes place (the latter actually looks at the first year after the buyout; information for the year prior to the buyout is not available).

Taxes

In the large BvD database, we witness a decrease in taxes paid by companies in the period from one year prior to the buyout until three years after the buyout, or until the moment of exit. The decrease in taxes paid is, however, not as large as among the control groups. This decrease in part might be explained by the financial crisis.

As mentioned earlier, the aforementioned findings are based on a small number of observations. Furthermore, major changes often occurred in the composition of the companies involved (see the disclaimers). It is therefore essential that these findings be interpreted and used with due caution.

7 CONCLUSIONS

Much like in the rest of the world, investments by private equity funds in the Netherlands increased strongly in the run-up to the financial crisis, fuelled in part by favourable market conditions (low interest rates, advantageous credit conditions, and good opportunities for selling companies). In the period after the crisis, a downward correction took place, but recovery quickly set in. Overall, one observes a continued growth of private equity over time.

The study supports the view that private equity has an added value as an ownership structure. It is not particularly short-term oriented with a horizon typically of four to seven years. Due to strong financial incentives (in part because of leverage), private equity adds urgency to accomplishing improvements in target companies. Private equity involvement brings financial clout, expertise and access to an external network. Via concentrated ownership, it also mitigates free-rider problems associated with public (i.e. exchange listed) ownership.

In historical terms, private equity has generated a return for its investors (limited partners) which is above that of a well-diversified equity portfolio, even after deducting costs and the considerable fees. We are referring here to limited partners who participate as investors from the outside. This history is also the most important reason why these investors are eager to participate in private equity. However, the spread in returns is large, and, when it its adjusted for unfavourable factors like reduced liquidity and higher risk compared with the benchmark, there seems to be no significant outperformance for the limited partners.

Our own analysis and the international literature show that private equity investment has a slightly positive effect on a company's performance in general. Private equity-financed companies in our Dutch sample grow somewhat faster and are slightly more profitable than comparable companies in the control group. The impact on employment is slightly negative compared to the control group. International evidence points at a marginal net loss of employment (to be expected, particularly in restructurings), but going hand in hand with gross employment creation.

The return that private equity funds achieve on their investments in target companies stem from a number of sources:

- operational improvements, including adjusting the strategic focus and facilitating growth;
- improving the governance structure by aligning interests and strengthening oversight;
- benefits associated with higher leverage;
- investment selection and market timing; a private equity firm's ability to track down undervalued buyout candidates (and take advantage of that by reselling them later at a higher price).

There are concerns however. The return for the private equity investor is not always true value creation, but could be based on redistribution effects at the expense of other stakeholders inside and

outside the company. This is an important area of concern in discussions on private equity, and points at possible conflicts of interest. The most important potential conflicts of interest between a private equity fund and other stakeholders are:

- an incentive to push heavily for fast-paced reorganisations, too much focused on cash payouts (high dividends) at the expense of investments in the business. More generally, taking an (overly) opportunistic approach. This can result in burdens for the company's employees, suppliers and customers;
- an incentive to significantly increase leverage to arbitrate (i.e. reduce) taxes paid, and create via insolvency risk an undue burden on creditors, suppliers (including a deterioration of payment terms) and ultimately employees and customers.

Our conclusion is that these conflicts undoubtedly do arise, but that excesses have occurred only in isolated incidents. Also, the likelihood of insolvency is only slightly higher than in companies with no private equity involvement. Reasons for this include: the proximity of private equity to the companies in which they invest, their ability to inject capital when needed, and the stronger negotiating position with regard to creditors. We also find no systematic evidence of harmful effects of private equity on employment and other stakeholders.

A more rigorous understanding of the forces leading to leverage is important given its presence in private equity investments and the controversy associated with it in the public debate. An obvious reason for leverage are the tax savings because of the possibility of deducting interest payments. Why such stimulus needs to be provided is not clear; in many countries – like the Netherlands – limits are being introduced. However, private equity investors have also other reasons for financing buyouts with relatively large amounts of debt. Debt makes the fund's return on its equity investment more sensitive to performance; i.e. it provides extra rewards for return enhancing actions. Debt also creates a sense of urgency. The high leverage 'demands' action, which is particularly important when a restructuring is needed. It also enables more investments to be made with a set amount of equity (this has a positive impact on, for example, the private equity general partners' compensation). Finally, it can help the company in pushing for concessions from other stakeholders (e.g. due to the burden of leverage, they may be more prepared to make concessions). Particularly the latter, but also the tax benefits, point at advantages gained at the expense of other parties, and thus are based on redistribution of value rather than a 'real' increase in the value of the company. Overall one may conclude that leverage exists for several reasons, and just limiting or even abolishing tax benefits will not have it disappear, but might help contain it.

Conflicts of interest may also arise between the general and limited partners in a private equity fund. The general partner often has an interest in the size of the fund and therefore may have different concerns than the limited partners. The fee structure can also result in conflicts of interest between the general and limited partners. General partners are closer to the company in which the fund invests and

extract considerable fees. Although general partners benefit from having a good reputation among limited partners – they will need to find limited partners in the future too – ultimately, there remains a potential for conflict. The danger of conflicts of interest must not be understated. More pressure from the limited partners would be a welcome development, and transparency in limited partnership agreements could help bring this about. The recent guidelines developed by the Dutch pension fund PGGM push in this direction, but it is unclear how effective they are, and to what extent they apply to the sector as a whole. Appropriate governance, both within the buyout companies and the organisations that the limited partners belong to (specifically, institutional investors), is crucial. As these are business transactions involving large institutions, the scope for government interference is limited; in the end these are business decisions and responsibilities.

Nevertheless, it is legitimate to have concerns. International standards might offer little protection and transparency is limited. Institutional investors (e.g. pension funds as limited partners) might not be able to offer sufficient counterweight vis-à-vis the general partners in private equity funds. Also, the transaction process leading up to a buyout deserves attention. Prior to a buyout, management of a target company might be in a conflicting situation. In particular, private equity investors have an interest in acquiring shares in the target company for as little as possible. Because the company's management might be enticed with the promise of a post-buyout role (including equity-based compensation), it may have an interest in driving down the share price prior to the transaction. This is damaging to the existing ('old') shareholders and relates to the more general topic of protecting the interests of minority shareholders. It is essential for the company's board (particularly its non-executive directors) to take the right position and keep its management's own interests in check, and thus protecting existing shareholders.[28]

Another area of attention is shareholder loans. These are considered legitimate sources of financing in their own right. The question is whether these loans should not be treated as equity which would therefore make them subordinated to other creditors' claims. This may prevent abuse.[29]

To conclude, further work on understanding the impact of private equity is important. Private equity plays a legitimate role, but more is needed to shed light on its operations. Particularly for the Netherlands, significant data problems need to be resolved. Access to data is limited. This is not just a problem for empirical analyses like in this study, but also limits public acceptance of private equity. Therefore, it is critical that more comprehensive databases will be created.[30]

[28] Also, the effectiveness of current regulations (see, for example, legislation in the area of directors' liability, the Dutch AIFM directive, and the interaction with insolvency legislation) needs to be regularly assessed.

[29] Tax deductibility for the interest paid on these loans is undesirable, to the extent that it still exists. Not only is it worrisome because of the burden it imposes on other taxpayers, it is primarily problematic for the improper conduct it entices. Interest deductibility on these loans has been abolished in the Dutch Tax Plan for 2017.

[30] The Nederlandse Vereniging van Participatiemaatschappijen (NVP) may be able to improve this situation, for example, by following in the footsteps of an initiative by the British Venture Capital Association (BVCA) to create a representative database. In an attempt to increase transparency and reporting in the area of private equity, the BVCA reports annually on the effects of a representative sample (see BVCA, 2015).

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