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HARNESSING INNOVATION IN LEVERAGED BUYOUTS: STRATEGIES FOR ENHANCING BUSINESS ACQUISITION SUCCESS

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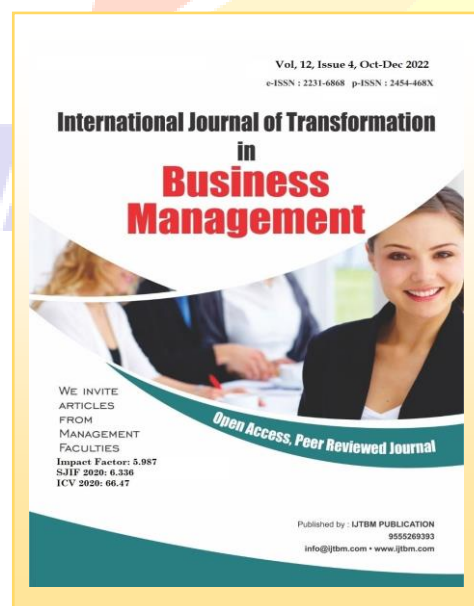
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ABSTRACT

This article explores the opportunities and challenges for PE LBO acquisitions. It presents potential mechanisms for successful financial outcomes for managers and organisations. It highlights three PE engagement phases with an LBO company: acquisition, planning, and execution. Many leveraged buyouts (LBOs) fail financially, negatively impacting their value chain. We investigate the impact of PE on innovation in PE LBOs. We offer insight into various factors that affect innovation and determine whether they contribute to acquisition failures. These factors include short-term ownership, management restructuring, incentive plans, and debt size factors on new product development and innovation. The platform helps leaders focus on innovation to improve investment and LBO success by streamlining decision-making and offering guidelines and recommendations. These principles may also support mergers and acquisitions (M&A) within organisations.

INTRODUCTION

THE United States' private equity (PE) leveraged buyout (LBO) market in 2019 was \$208 billion and included 1329 LBOs [1]. In this market, PE firms raise funds from institutional and wealthy individual investors to acquire, manage, and sell businesses. Once capital is committed to a fund, investors have minimal influence on the management of the fund's assets. PE funds are closed and liquidated by selling all associated businesses after a predetermined time, typically 10 years.

Annual returns on investment (ROI) of 12%–20% on previous investments enables PE firms to raise money for new funds [2], [3]. In turn, PE firms can charge their investors a 1.5%–2% fee on assets under management and a 20% fee on all fund profits.

Despite PE's widespread appeal, little is known about PE firms' finances and day-to-day operations because they are not subject to public disclosure regulations [4]. The short-term view of PE portfolio businesses frequently suppresses long-term growth, such as investments in technology and innovation [5, 6]. On the other hand, these portfolio businesses are more effective and focus on long-term expansion [2], [7]. Notwithstanding these disparate viewpoints, all LBOs fail [8]. Out of 12,267 buyouts in the UK between 1985 and 2005, 1431 (12%) LBOs failed due to some default. These findings suggest that conducting more research to pinpoint the causes of unfavourable financial outcomes and offer suggestions will boost success rates. We pay particular attention to the function of innovation in this piece.

The impact of certain innovation elements on PE LBO performance is explored, including ownership terms, management restructuring, management incentive plans, and debt amounts. We provide a systematic approach to decision-making that will enable PE investments to be profitable while also benefiting LBO workers, associated value chains, and the local community.

RESEARCH DESIGN AND DATA COLLECTION

After assessing the variables that affect innovation, the main goal of this research is to create a platform that makes decision-making more accessible and offers guidelines and recommendations to help raise leadership attention to innovation and improve the success rates of LBOs and mergers and acquisitions (M&A) in general.

Information was gathered from LBO executives through personal interviews based on case study surveys. The questionnaire included closed-ended questions to ensure consistency in the results. Participants were free to elaborate on their responses during interviews, even though the main focus was responding to closed-ended questions. Some even offered qualitative narratives. Closed-

ended question responses were combined to allow the finding patterns that correspond to the variables influencing innovation. Twenty-two executives in prominent positions from four US midsize financial industry organisations were selected. The executives who participated in the study did not have a conflict of interest because they were no longer connected to the chosen LBOs.

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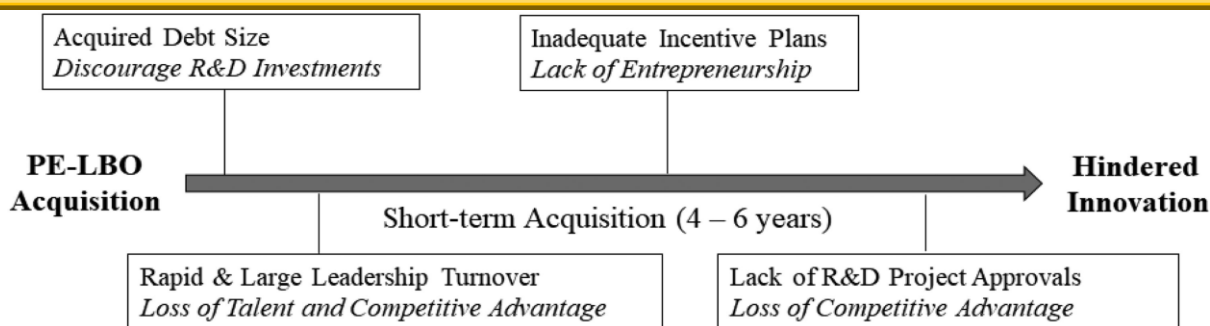


Figure 1. Four factors that impact innovation

To ensure uniform data collection, the survey-based interview questions were closed-ended and addressed subjects that examined the four fictitious variables (F1–F4) that affect innovation in PE LBOs. Descriptive and correlative statistics were used to compile and analyse the survey's results. Based on the comments, strategic guidelines were created to support innovation and profitable investment outcomes. To validate the overall premise and associated criteria, case study surveys of seven professionals with an average of over 22 years of experience in business, finance, engineering, marketing, and product management were required (see Figure 1).

RESULTS

A. How Short-Term Investment Affects Innovation

The participating companies' names are A, B, C, and D to preserve anonymity. It was vital to determine successful and unsuccessful LBO metrics, verify the length of PE LBO ownership, and assess participant credibility

before looking into factors F1–F4. According to the LBO investment exit financials, if the PE and investors lost money, the business was deemed a failure. As a result, even if business C hasn't sold its investment, most respondents (more than 80%) reported that company C is failing due to a poor return on investment for the PE investors. Additionally, the originality and reliability of the data are enhanced by the fact that the participants were LBO executives who held important positions in senior management (CxO, Senior Vice President), second level management (Vice President), and possessed distinct knowledge that is crucial for this research project. Their unique insights significantly contribute to the quality of the research. Finally, the average survey result of 7 years supported previous research indicating that PE ownership had a brief duration [14]. Project approval close to the end of the investment period was assessed in order to look into how short-term ownership periods affect innovation and the development of new products.

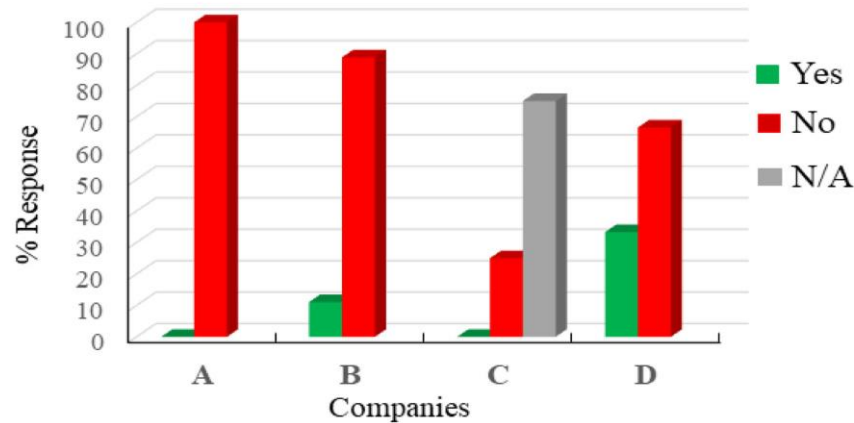
Findings in Figure 2(A) indicate that businesses A, B, and D were unlikely to accept new product development initiatives that would finish after the exit. Since Business C's PE ownership period is almost five years long and its exit date is still pending, this criterion did not apply. Notably, 2-3 years before the exit event, PE companies that had previously expanded their R&D expenditure ceased doing so. The time spent developing new products at each LBO provides insight into the crucial moment PE companies will cease sponsoring new product development.

Given that business A's product development took place over 1-2 years, Figure 2(B) shows that new product development was not approved during the latter 1-2 years of PE ownership. Results indicate that during the final two years of the PE ownership, business B only authorised new product development projects despite having a greater variety of

product development project durations of up to three years. The results in Figure 3 (A), which demonstrate that Company B only increased the R&D expenditure during years three through six of the eight-year PE ownership, support this conclusion. Since Company C has not increased its R&D budget during the first three years of PE ownership and its new product development project duration was one to three years, it is expected that Company C will stop approving new projects in the final one to three years of the investment period. On the other hand, company D's latest project length range was more significant than company B's, where it was determined that most new projects lasted less than a year. Projects lasting less than a year would probably be approved even during the final year of ownership, as evidenced by the findings in Figure 3(A), which demonstrate that Company D carefully boosted R&D spending when necessary.

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A. Pre-Exit Project Approval



B. New Product Development Duration

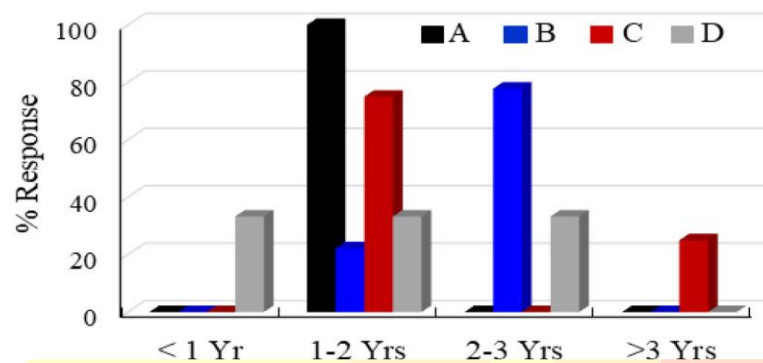


Figure 2. Approval of new development projects that will complete after investment exit.

The findings presented in Figure 2 indicate that during the last 1-2 years of the investment, it is improbable that the LBO leadership of the four companies will consent to the creation of new products.

B. Influence of Debt Management on LBOs Innovation

Actions One aspect affecting innovation is the amount of debt (F2) an LBO controls. According to the results, companies A and B had the least debt (less than 70% of the purchase price). In this case, firm C functioned in a mature, low-growth sector with relatively high debt (80%–90%) in the

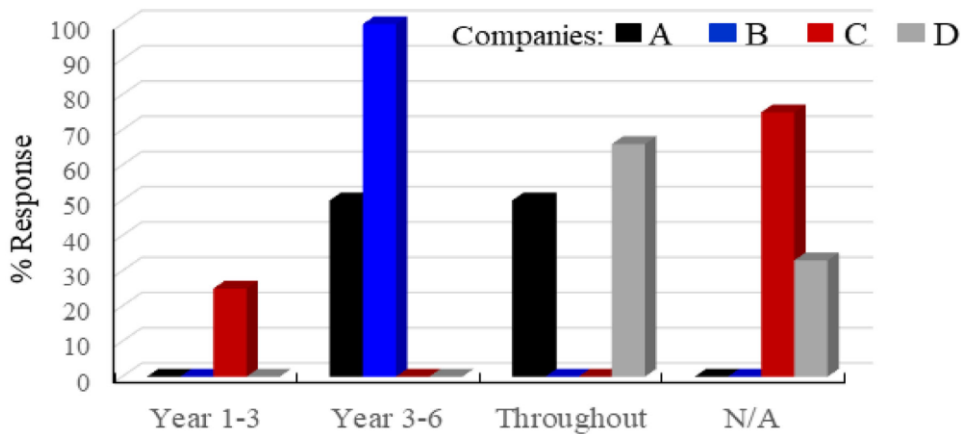
investment mix, while company D operated in a high-growth market with a lower debt-to-equity ratio (70%–75%). Figure 3(A) demonstrates that firm C did not boost R&D investments, given the extent of the debt. As an alternative, Figure 3(A) showed that the budgets for R&D at businesses A, B, and D rose, as well as when these increases occurred [see Figure 3 (A)]. Correlation analysis in Figure 3(B) shows an inverse relationship between debt size and increased R&D investment, which is confirmed by the negative correlation ($r \frac{1}{4} -0.74$) between variables.

C. Influence of Management Restructuring on LBOs Performance

Alignment of LBO management with the PE firm’s objective is another important factor.

Table 1 summarizes results that show

A. Product Development Budget Increase



B. Debt vs. Innovation

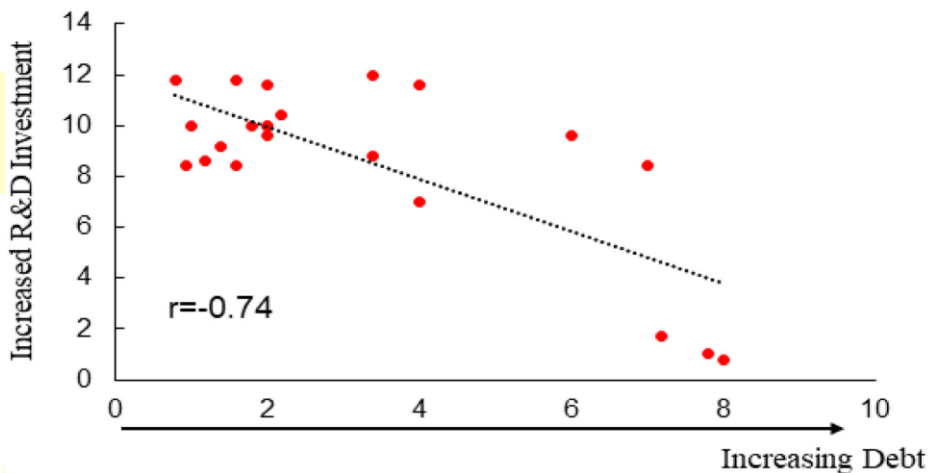


Figure 3. Product development budget increase and the correlation between debt and innovation at the participating LBOs.

The senior management turnover rate across the four LBOs is related to the length of the process of restructuring the leadership and the consequent loss of talent due to employee departures. Less than 20% of senior managers were replaced by Companies A

and B, more than 60% of the senior management team at Company C was replaced in less than a year, and less than 60% of the senior management at Company D was replaced in the first two years. It's interesting to observe that businesses A and

B, who made relatively few changes to their leadership, retained their talent. Greater talent loss resulted from Company C's senior management team replacing most of them quickly. The contradictory statistics from Company D suggest that either the new replacement actions either did not spread throughout the organisation and largely escaped the attention of next layer management, resulting in little to no loss of talent, or the leadership was strong and contributed value and success to firm D.

D. Influence of Incentive Plans on Leadership Behaviour

This article examines the components of the incentive plan (F4) and assesses its capacity to inspire long-term, innovative activities, provide a healthy balance between short—and long-term behaviour, and match the LBO's leadership with the investors' (PE).

The findings show that senior teams at the four organisations were compensated with high salaries, stock options, and bonuses. Upon examining the stock options plans presented in Figure 4(A), it can be observed that Company D offered the most generous plan, with participants gaining ownership of restricted shares or time-based vesting options. Due to the time-based vested stock options, Company A had the next best plan.. Plans for stock options were offered by Companies B and C, and they vested

according to performance and time. While Company C's performance goals were predicated on an inflated company valuation at the investment exit, Company B's performance vesting was attainable and aligned with annual goals. The executives were no longer motivated by the idea, and at the time of the poll, the options' value was less than their exercise price. The executives of businesses A, B, and D were driven to invest in long-term inventive activities because they thought their alternatives would be a life-changing event or a significant addition to their fortune upon investment exit. According to the bonus plans for the four firms (refer to Figure 4(B)), most participants were granted an annual bonus plan that accounted for between 30% and 60% of their income, which is a substantial additional remuneration. The survey results indicate that business C had an uneven incentive mix that rewarded short-term success with high annual bonuses and an unrealistic stock options plan rather than stimulating long-term investment in innovation. This finding is significant. A robust bonus plan and a comparatively excellent stock options plan were part of Company B's incentive plan mix, which encouraged long-term creative behaviour at the executive level. Furthermore, the PE firm's repricing of the stock options during the financial crisis significantly inspired the executive team. This action resulted in a

committed executive team that invested its time and energy in the success of the company. Results in Figure 4(C) show a positive correlation between the stock options plan (variable 1) and R&D spend during the investment period (variable 2) with a positive correlation ($r = 0.58$) between the two variables.

In summary, results demonstrate that due to the short-term nature of the investment period, new product development projects are unlikely to be approved as a company nears the final years of the investment horizon.

Additional findings indicate that the amount of debt has an indirect relationship with increases in R&D spending, and that there is a strong correlation between talent loss and a decline in business performance and the size and speed of leadership team reorganisation. Furthermore, the outcomes verified that the private equity firm that enforced the most stringent policies for the stock options scheme led to a management team lacking in creativity. The private equity firm recognised the possible drawbacks of a stock option plan that was not working and made the necessary adjustments to make sure the LBO leadership made long-term innovative investments that eventually produced positive financial results. Based on the analysis of the four factors that are key to success of the innovative process, a set of recommended

guidelines in the form of flowcharts were created to help improve the success rate and outcome of PE investments.

RECOMMENDATIONS AND GUIDELINES

A. Application of PE LBO Guidelines in Phases: Recommended guidelines that pertain to the factors (F1–F4) that impact innovation in PE LBOs were created using the survey results from 22 executives in four LBOs. These guidelines were validated and calibrated via case studies with seven senior-level expert executives that weighed in on three PE ownership phases (see Figure 5) that include: an acquisition phase, a planning phase, and an execution phase. The proposed guidelines in these three phases apply to a variety of PE LBO scenarios and broader M&A activities. The objective is that PE firm partners and LBO executives can achieve successful outcomes through the application of the guidelines during the acquisition, planning, and execution ownership phases—shown in Figure 5. B. Acquisition Phase: Guidelines related to F1—debt size—are best implemented in the acquisition phase. During this phase, the PE firm performs due diligence. It engages with the target company, reviews its financials, meets with its customers, vendors, creditors, and leaders, and decides whether they should acquire the company. Some decisions made during this phase are the purchase price and

the investment mix. The flow diagram in Figure 6 depicts a decision-making process related to the debt size. The process starts with a leverage ratio calculation, which is the debt size divided by EBITDA (earnings before interest, tax, depreciation, and

amortization). If the ratio is greater than 5, product and customer due diligence should be completed to determine whether major R&D investment will be required during the PE ownership.

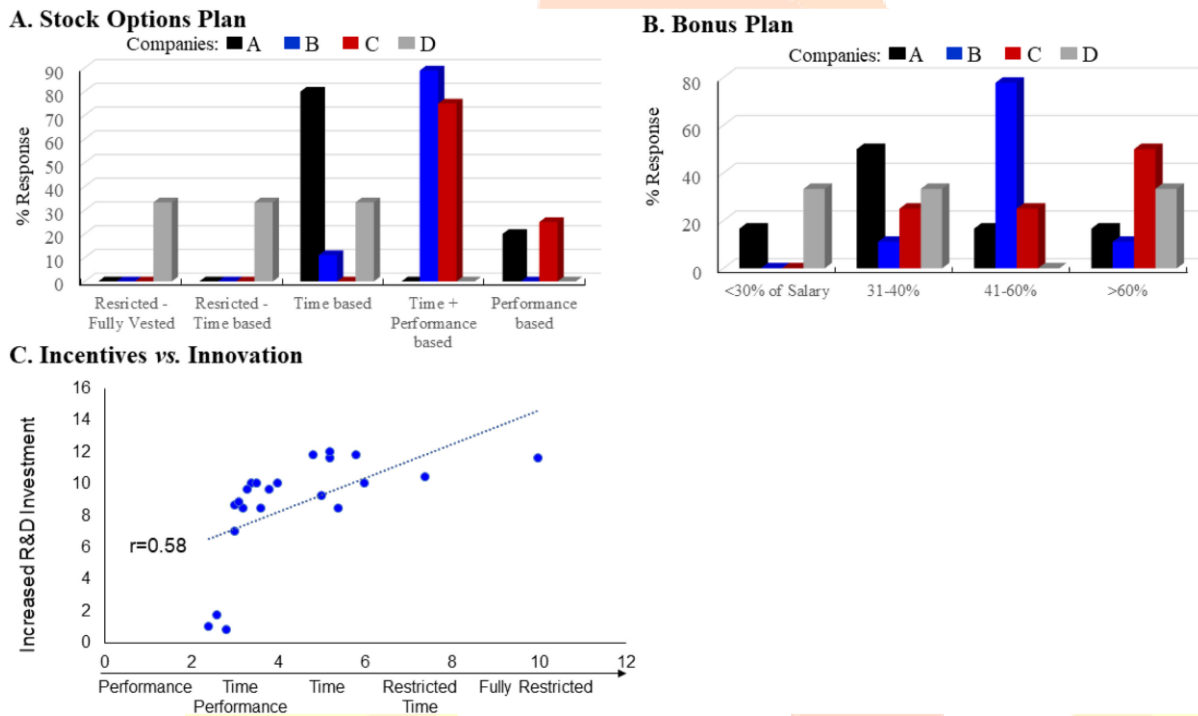


Figure 4. Stock options plan, bonus plan, and statistical correlation between incentives and innovation at the participating LBOs

If necessary (less than X years), assess the competitive environment to determine whether postponing the creation of new products will reduce their worth throughout ownership. If competitors already have or are developing a better product, reduce the amount of debt and raise the equity component of the investment mix. This will allow the LBO to save money for funding crucial product development projects.

No debt change is anticipated if the ratio is less than or equal to 5. However, a "lightweight" product and customer due diligence should still be carried out to verify the acquired company's sales presentation.

C. Planning Phase: During the planning phase, which comes just after the acquisition, guidelines for the F2 factor—significant and quick management replacements—have the most influence. Process processes and

decisions for the executive management team's reorganisation are depicted in Figure 7. The choice made by the PE firm regarding whether to retain or swap out the CEO. We won't go into the details of this initial option because it is a nontrivial exercise in and of itself. Nonetheless, within the first two years of ownership, CEO turnover in PE LBOs exceeds 50%, and the likelihood of turnover is considerably higher in LBOs experiencing cash flow issues [15]. The best CEOs for PE

LBOs should be able to enhance the senior management team's competencies, foster alignment and commitment to their vision, and think strategically and methodically [16]. Whether it is a new or current CEO, when the decision is taken, the CEO leads the creation of the executive team through two concurrent processes. In the initial segment, the CEO speaks with current executives, their peers, and potential successors.

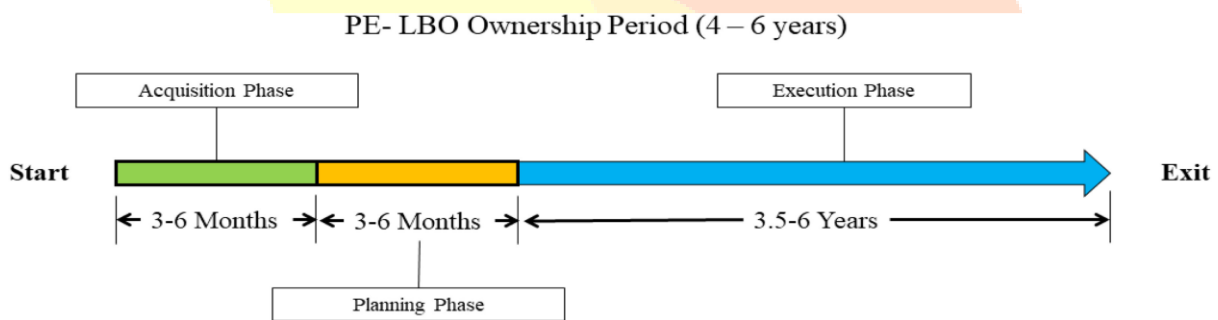


Figure 5. PE ownership phases with LBO company.

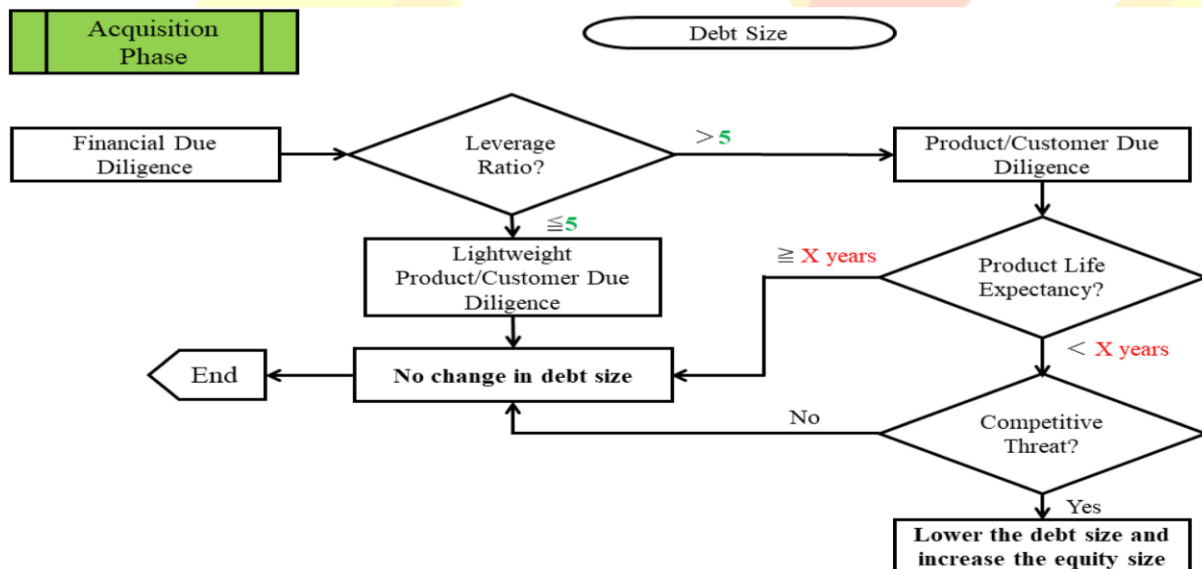


Figure 6. Process and guidelines to determine the debt size. In green, Leverage Ratio $\frac{1}{4}$ Debt Size Divided by EBITDA. In red, expected LBO Exit $\frac{1}{4}$ X years. EBITDA: earnings before interest, tax, depreciation, and amortization.

This enables the CEO to decide which executives should be kept or replaced. The second track is designed to mitigate risks associated with replacing executives and is focused on interviewing a large sample of employees. These interviews identify potential risks that could lead to loss of talent and mitigate them. Talent management risks include culture change, switching loyalty, and career aspirations of employees that could go unnoticed. These interviews should identify key employees that ought to be retained to prevent talent loss.

The recommendations for mitigating these risks are divided into two groups. The first one covers the rate of termination of existing executives to help reduce the impact on employees by limiting the rate of executive replacements to no more than X executives in a Y month's period while also ensuring that executives with product and market knowledge do not depart at the same period. X and Y should be adjusted based on the size of the executive team and the time it will take for replacements to become proficient in these business areas. The second group of recommendations is designed to retain key employees that are critical to the success of the organization. This process identifies career growth opportunities for these employees and includes recommendations for the creation of incentive and severance plans. The second recommended guidelines

for the planning phase are linked to the F3 factor—management incentive plan. Figure 8 illustrates three components that should be addressed by the PE firms. The first component covers the plan for incentivizing the senior management team. The stock options value must be high enough to represent a life changing or a strong additional income event for the recipients—with performance objectives that are audacious but achievable. The second component covers the plan for middle management and key employees with a focus on retention. The stock options should include a strong component that is time-based vested. The plan should also include a long-term bonus plan that is tied to achieving product development objectives, and the overall compensation should carry a value of 50%–100% of the participants' annual income. The third component of the incentive plan targets the PE firm partners who may adjust the stock option plan as required if the ability to achieve the objectives have been impacted by external events.

D. Execution Phase: Guidelines related to the F4 factor—R&D

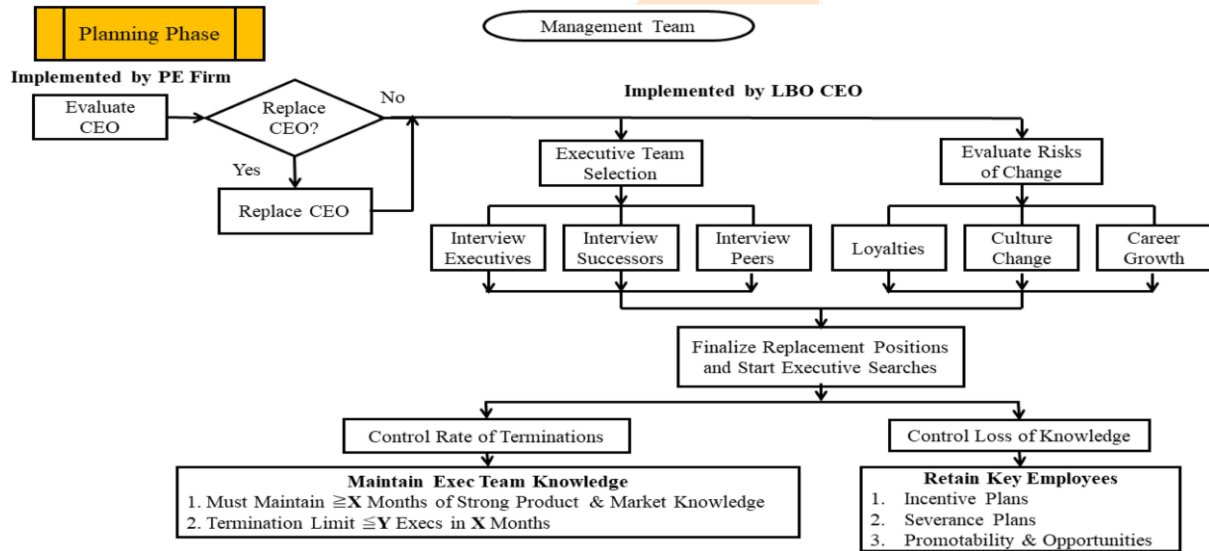


Figure 7. Management team creation process and guidelines. Business Knowledge Acquisition $\frac{1}{4}$ X Month; % of Leadership Termination Limit $\frac{1}{4}$ Y.

approval—should be implemented in the execution phase (see Figure 9) and address the project approval process. The first decision point is to determine whether the LBO exit will occur prior to the end of the project (less than Y years). If the LBO exit occurs after project completion (greater than Y years), then the project should be approved based on its business plan. If the project completes after the LBO exit (less than Y years), then the next decision point is whether the product will generate revenues before the LBO exit. If product revenues are generated prior to the LBO exit (less than X years), then the project should be approved

based on its business plan. If revenues are generated only after the exit (greater than X years), then the executive team should determine if the project fits into an offensive (market expansion) or defensive (product enhancements) product strategy. If the strategy is offensive, then the executive team should reject the project if they intend to sell the business to a financial buyer (PE firm) that is risk averse, and approve it if the buyer is strategic and is interested in product expansion. Conversely, with a defensive product strategy and the buyer is financial, then the project should be approved;

otherwise, if the buyer is strategic, it should be rejected.

Broader M&A market implications: An additional case study survey was conducted to determine whether the guidelines can apply to the broader M&A market. The seven experts that were interviewed believed that the guidelines are very applicable to a broader market and provided additional input that clarifies whether the acquired or acquiring company should be implementing

the recommended guidelines. In the case of the F1 guidelines, an acquired company should use the guidelines as part of a strategy to be acquired. F2 guidelines should be used by an acquiring company if they intend to use creditors as part of the acquisition. F3 and F4 guidelines should be used by an acquiring company if their strategy is a market expansion where the acquired senior management team must be retained and motivated to execute the acquirer’s strategy.

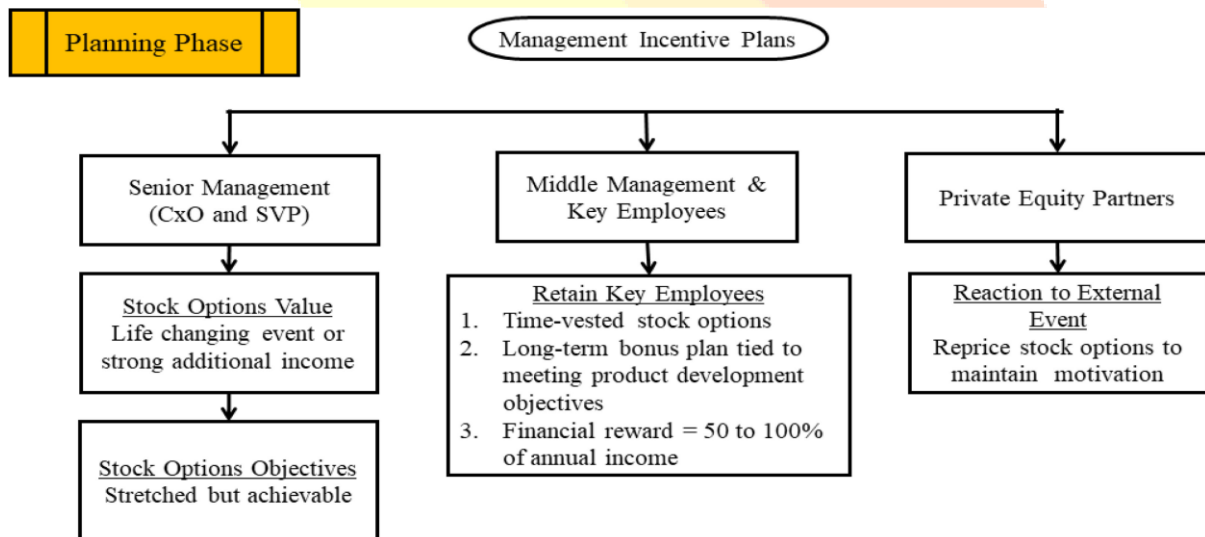


Figure 8. Incentive plan creation process.

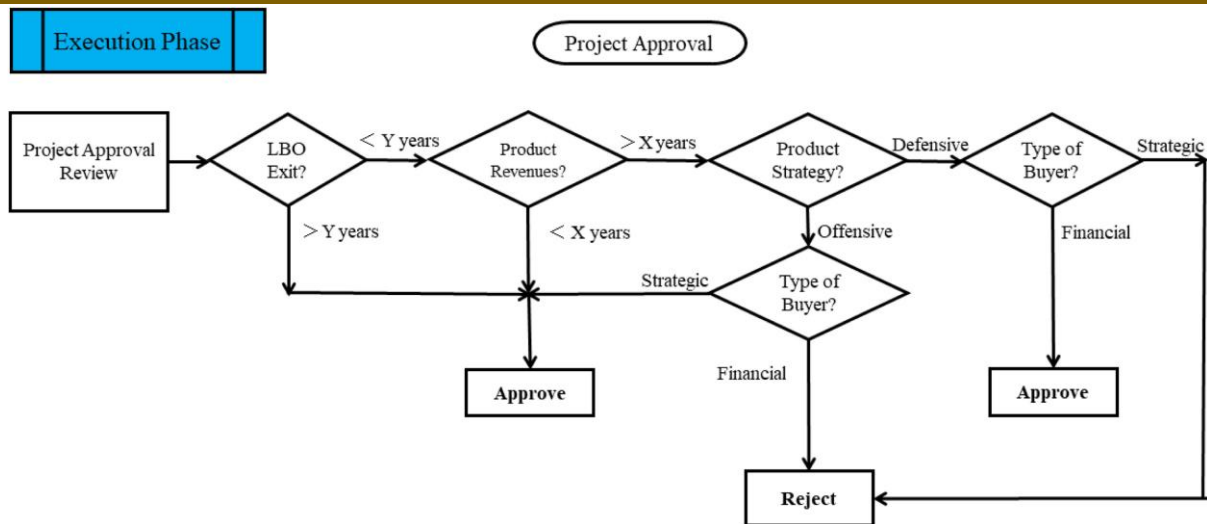


Figure 9. Recommendations for project approval. Explanation of terms: Expected LBO Exit $\frac{1}{4}$ X years; Product Development

Duration $\frac{1}{4}$ Y years; EBITDA: Earnings Before Interest, Tax, Depreciation, and Amortization; Offensive Strategy: market expansion;

Defensive Strategy: product enhancements; Financial Buyer: PE; Strategic Buyer: company that wants to expand its market.

CONCLUSION

The purpose of this article was to investigate the influence of leadership on innovation in PE LBOs, exploring hypothetical factors that impact innovation and how they correlate to LBO failures. The overarching hypothesis that PE practices influence organic R&D innovation in PE LBOs was validated, including the four related factors.

The research generated four recommended process guidelines in the form of flowcharts that are associated with the four factors. These guidelines are designed to ensure a successful PE investment outcome and product development decisions. A follow-up

survey was conducted with an expert group of top executives from PE LBOs that served to calibrate the hypothetical factors and the recommended guidelines.

An additional case study survey was conducted to determine whether the guidelines can apply to the broader M&A market. The experts believed that the guidelines are strongly applicable to a broader market with minor adjustments.

In summary, during 2019, the US PE market had 1329 LBO deals and the broader M&A market deals were at 12 700. Utilizing the guidelines as a blueprint for success in the PE LBO and the broader M&A can improve

investments outcomes and help their LBO employees, value chain, and surrounding community economy.

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