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MANAGEMENT BUYOUTS
The history of an organizational innovation

Steven Toms

Introduction

The sources of finance invested in growth sectors have long influenced the character of UK industry and indeed industries that have emerged and developed in many international contexts. Venture capital has a long history in the provision of growth finance and finance for restructuring in the UK (Wright et al., 2000; Toms et al., 2016). Even in such a long-run perspective, the buyout wave of the 1970s that began in the UK and the US and spread rapidly internationally, was nonetheless a revolutionary development. The parallel emergence of private equity (PE) (see Gilligan, Chapter 2 this volume) underpinned new opportunities for entrepreneurial groups of managers to restructure their businesses and enhance performance. That such developments might seem revolutionary, or even surprising, requires some contextual understanding of the evolution of finance for industry up to 1970.

The corporatization of a substantial number of economic sectors, particularly after 1945 and culminating in the wave of corporate takeovers in the 1960s, created a landscape dominated by powerful conglomerates. There were observable negative consequences. There was talk of the demise of the entrepreneur. Stock markets meanwhile attributed discounts to conglomerates, suggesting that they had become unwieldy and over-diversified. All of this developed against a backdrop of intensifying global competition that challenged the dominance of US, UK and European businesses in a number of markets.

In short, conditions were ripe for the emergence of the MBO/PE model by 1975. But when and why had the demise of the entrepreneur occurred, or at least, how was their function apparently subsumed by the corporate model? And what processes led to the over-diversification of the big corporates, and how and why were the smaller businesses that did not become divisions of bigger firms starved of the finance they needed for restructuring and expansion?

The chapter will provide answers to these questions, tracing the character of UK entrepreneurial finance over the long run. In doing so, it considers some early cases of venture capital and buyouts, not hitherto classified as such or considered in the literature. It will identify the reasons for the emergence of a financing gap for growing businesses that was eventually filled by the MBO/PE wave post 1980s. In doing so it will examine differences between the UK and US application of the buyout model. It will then reconsider recent trends in business finance before and after the global financial crisis of 2007 in the context of longer-run
patterns in financing. It will conclude with a discussion of the overall contribution of MBOs to economic development and briefly look ahead to consider future challenges.

Entrepreneurial finance, c.1770–1975

The earliest innovators of the industrial revolution were in many ways the most famous. James Watt’s modification of Thomas Newcomen’s original engine provided steam power with the efficiency and scale necessary for the industrial revolution. Inventors like Watt depended on patent protection, which was not always easy to sustain, as Arkwright’s experience with spinning frames demonstrated.

Whereas the evidence on whether intellectual property speeded or slowed the industrial revolution is mixed, there is less doubt about the role of finance. James Watt’s partner, Matthew Boulton, was an early example of a venture capitalist, who used wealth from his network of multiple partnerships to support investment in a wide range of industries, from toy manufacture, to mining, and to minting coinage. Boulton’s support for Watt’s engine ensured its long-run success, providing the finance needed to develop a range of improved engines that could be applied in a wide range of innovative contexts. In similar vein, Arkwright was able to develop commercial scale for his inventions through partnership with established money (Dutton, 1984: 188; Toms & Fleischman, 2015).

A notable feature of the firms of these new industrial firms, however, was their independence from established sources of metropolitan finance. By 1770, London was already an established financial center, based on the wealth of its powerful merchant class. Led by institutions like Rothschilds and Barings, it underwent further dramatic expansion in the nineteenth century (Chapman, 2005). The City of London had its own priorities, driven by the growth of empire and associated infrastructure and commodity investments, and notwithstanding the opportunities that arose from rapid industrialization, remained largely aloof throughout the nineteenth century. Part of the reason was that although industrialization was highly significant as a whole, the financing needs of industrial firms were small relative to, for example, international bond issues for foreign governments (Kynaston, 1995). Frauds, mispricing, and lack of regulation over new stock issues led to disappointment and financial losses for metropolitan investors who did invest in domestic issues, most notably during the railway booms of the 1840s and 1850s (Robb, 2002).

The introduction of joint stock legislation in the 1860s, meanwhile, provided new opportunities for industrialists to raise equity finance. Regional stock markets successfully mobilized local pools of saving and gave rise to new classes of middle and working class investors (Toms, 2001; Thomas, 2013). Through a process of merger, banks developed branch structures that could also service the needs of local industry, albeit restricting such lending to working capital finance.

Notwithstanding the disparate uses of metropolitan and regional finance, London offered some examples of venture capital style finance. Syndicates were created to attract pools of investor finance that could be deployed in risky overseas ventures. For example, the Northumberland Mining Syndicate made serial and portfolio investments in highly risky mining claims in southern Africa during the 1890s (Michie, 1981). The Cycle Industries Trust, formed in 1896 at the height of the bicycle and pneumatic tire boom, was a venture fund backed by debentures, with the purpose of purchasing or securing cash flows from patent acquisition; an early example also perhaps of securitization. Horatio Bottomley, who founded the Financial Times in 1888, set up the Joint Stock Trust, formed on similar lines, although its scope was not confined to a single industry (Taylor, 2013). Once again, the
experience of London investors with these schemes and associated promotion booms was negative, not least because promoters like Bottomley used fraudulent methods and achieved notoriety as a consequence. Citing a 1904 source, Michie (1981) notes that investors in joint stock firms had lost more money than they gained. Financial institutions did not replace individual company promoters until the 1920s (Roberts, 1993: 33), so before then innovative entrepreneurs seeking to exit their investments through initial public offerings faced commensurately higher risk.

If London provided early examples of venture capital provision, smaller regional enterprises offered examples of management buyouts. Indeed such early historical examples are perhaps more common than might be supposed, given that the term only came into general use quite recently and has been applied thus far to describe a post 1980s phenomenon. According to the standard definition, although not described as such by contemporaries, the cotton textile industry was effectively restructured in a buyout wave during the 1890s. Up to around 1896, share prices of publicly quoted cotton mills were depressed by world market conditions. In view of the prolonged depression, many smaller shareholders, including the mill operatives, were keen to sell. An opportunity was thereby created for mill directors to purchase controlling interests in their own companies at low prices. Once control was achieved, the firms increasingly resembled private companies: stock exchange listings were removed, directors’ salaries increased, and the publication of accounts was suspended (Toms, 2002). The performance consequences of the buyout wave are difficult to evaluate in the short run. World market conditions recovered quickly after 1896, driven by changed monetary conditions, so the restored profitability of cotton firms does not necessarily reflect the policies of the new owners.

However, the restructuring of the cotton industry along these lines had longer-run consequences that can be traced to the origins of the new buyout wave that impacted the wider UK economy during the 1970s. The British economy of 1900 has been criticized for being dominated by personal capitalists, who failed to innovate (Chandler, 1990). However, this was not exactly true of the managerially controlled cotton mills. The directors used the profits from the mills they already controlled to launch new, more modern mills on a larger scale. These were effectively groups of mills run by syndicates of interlocking directors and investors (Higgins et al., 2015). A series of mill flotation waves expanded the industry, according to some, by too much, so that after the final mill promotion wave of 1920, overcapitalized businesses were in control of too much capacity (Keynes, 1981). Attempts to restructure the industry and to remove these problems were mostly unsuccessful, including a forced amalgamation scheme instigated by the Bank of England in 1929 (Filatotchev & Toms, 2003).

The problems of the textile industry mirrored other staple industrial sectors and hinted at financial problems that were to affect British industry for decades to come. Cotton, like many other industries, utilized bank lending to finance working capital, but lacked access to venture capital and finance for restructurings. The regional stock markets, which had fuelled growth in the nineteenth century, now fell into decline along with the staple industries they mostly served. The long-term financing problem was recognized as early as 1931, referred to by policy makers as the “Macmillan gap.” By 2010, the same problem was referred to as the “equity gap” (Green, 2010; Toms et al., 2016).

The gap persisted until the 1970s, so that the buyout wave to some extent filled a vacuum. Earlier attempts to provide long-term capital for industry came from the Bank of England. The Industrial and Commercial Finance Corporation (ICFC), which later became Finance for Industry (FFI) and eventually 3i, had a very limited impact before 1970. ICFC was set up by the clearing banks in 1945. It was criticized for being overcautious in supporting funding applications and was deliberately and consistently under-resourced by the banks.
As a consequence there was limited scrutiny of investee companies compared to the model that developed later under the auspices of PE (Toms et al., 2016). Writing as early as 1950, a commentator in The Economist neatly encapsulated the ICFC’s present and future impact as “performing a moderately useful function in a moderately cautious way.”

A private sector business model that attempted to perform venture capital functions, as characterized by portfolio holdings of high-risk investments requiring expertise and financial support, ended in disaster with the Slater Walker collapse of 1975. Founded and led by entrepreneur Jim Slater, the majority of Slater Walker’s transactions were motivated by asset stripping. Valuable assets, particularly property, were sold at good profits, and the maximum cash extracted from the remainder of the assets. Traditional industrial firms acquired by Slater Walker, like Crittall Hope, were effectively destroyed by these practices. In the absence of regulation, the Slater Walker conglomerate also included its own banking division, whose main assets included intercompany loans secured against what proved to be optimistic valuations, once the property boom had turned to bust (Hope, 1976; Raw, 1977; Toms et al., 2016). As a variant of the conglomerate model incorporating some venture capitalist features, Slater Walker revealed serious inadequacies in the provision of entrepreneurial finance via the London Stock Exchange. Many of these weaknesses were subsequently overcome by the emergence of the PE-backed MBO model.

The buyout wave of the 1980s

Although Slater Walker’s principal activity had been buying and selling companies, and occasionally investing in those it believed had good prospects, to some extent it typified the conglomerate organization of wider industry. The rise of the managerially controlled corporation and the separation of ownership and control, as recognized by Berle and Means (1991 [1932]) in the 1930s, led Joseph Schumpeter (1976 [1942]) to pronounce the demise of the entrepreneur. In its place came the “techno-structure,” a term coined by Galbraith (2015) in 1967 to describe the dominance of production by managerial and technical specialists, backed by government policies that promoted amalgamations. The inauguration of the market for corporate control in the 1960s (Manne, 1965) in the US and the UK meant that the ownership of these large businesses became a matter of managerial competition that tended to subsume other entrepreneurial activities.

The recession of the 1970s posed what proved to be an insuperable challenge to the managerially controlled conglomerate. Ironically, the problems began with the Barber inspired property boom and the subsequent collapse and banking crisis that destroyed Slater Walker (Reid, 1982). The oil crisis added to these problems and firms found themselves overextended. Conglomerates typically traded at higher discounts than their more focused less diversified competitors, not least because they preferred to sit on large cash surpluses, either because they could not be productively reinvested, or due to restrictions on share buybacks, GEC being a leading example (Toms & Wright, 2002).

In the UK, the 1973 crisis had led to the creation of FFI, a successor organization to the ICFC, now expanded with additional funding from the Bank of England. The new organization was more explicitly oriented to venture capital functions. As such, before and after its relaunch as 3i, it was in a good position to support the earliest of the new MBO style transactions (Toms et al., 2016).

Poor macro-economic conditions meanwhile led to rapidly rising unemployment. It was against this backdrop that some of these early buyouts occurred, providing employees with the opportunity to buy their own companies, rather than face redundancy. The new
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buyout market, which gained momentum in the late 1970s and early 1980s, thus involved recession-related restructurings of failed or distressed companies (Wright et al., 2006). These examples were fairly isolated, and further reform at institutional level was needed to give substantive impetus to the developing wave of buyouts. The introduction of the unlisted securities market provided greater liquidity, and in parallel deregulation promoted the new entrants and greater shareholder activism. Banks, particularly those new to London and unconstrained by the traditional practices of the City, led the way in developing venture capital funds. Citicorp Venture Capital (CVC), a subsidiary of the US commercial banking giant Citicorp developed strong links with Silicon Valley and expanded into Europe in 1974 and subsequently into London in 1980, thereby becoming the first of such organizations to begin operations in the UK. It was quickly followed by similar banking organizations (Lorenz, 1985: 12; Kenney & Florida, 2000).5

In the same year, a new Companies Act lifted restrictions on capital reduction through share buybacks and financial assistance for the purchase of a company’s own shares. These prohibitions had been enshrined in the Companies Act 1948, founded on the principles of minority and creditor protection. The provisions had also limited the scope for the use of the assets of target firms as security for debt-financed takeovers. Jim Slater, the Chief Executive of Salter Walker, was convicted for violation of these rules. Pressure to relax these provisions began with the Jenkins Committee in 1962, with an argument that private businesses should be exempt, and the increased perception in the 1970s that the restrictions limited the opportunities to rescue otherwise viable businesses (see Gilligan, Chapter 2 this volume). The Companies Act 1981, extended into the EU Second Directive and Companies Act 2006, relaxed these rules, offering safeguards to minority shareholders and creditors through statutory declarations by directors. These included the private company “whitewash” rules, where firms were allowed to give financial assistance if supported by a special resolution and a directors’ statement of solvency (Ferran & Ho, 2014: 232–233).6

An important reason for the failure of the conglomerate model had been the exhaustion of scale economies. New technology, developed in the early 1980s in particular promoted flexible specialization, including, for example, those technologies eagerly invested in by CVC in Silicon Valley, based on Computer Numerical Control (CNC) and Computer Aided Design (CAD). These methods now facilitated the exploitation of scope as opposed to scale economies.

These changes explain some of the outstanding features of the earliest MBOs after 1975. Prior to 1981, in part due to the lack of clarity on financial assistance, FFI’s legal expertise was an important element of support offered to fledgling buyout transactions. Subsequently, and more commonly, MBOs arose from conglomerate groups’ decisions to divest their subsidiaries. The impetus for these sales came from the increasing fragmentation of vertical supply and value chains. MBO companies were characterized by stronger monitoring by investors, notably through direct board representation combined with managerial equity stakes and incentives. Structured debt finance was a significant proportion of the whole package, thereby reducing free cash flow. Taken together, these factors created pressure for further divestment, including pressure to repay debt leading to the divestment of less productive activities. For example, the successful hostile leveraged buyout of Gateway Superstores in 1989 was accompanied by significant divestment of unwanted stores and divisions (Wright et al., 1994).

In such fashion, the MBO model assisted firms that wished to change strategy and refocus their activities. Coats Viyella had made a series of large acquisitions in the 1980s, a strategy predicated on building market share and bargaining power with retail giant Marks & Spencer. Coats had become a £2 billion turnover business by 1990, but had a large number of subsidiaries, many of which were locked into low margin high-risk contract work with retail
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Giant Marks & Spencer (Toms & Zhang, 2016). Financial pressures led to the appointment of a new Chief Executive, and a new focus on becoming a brand-led international services business. As part of this process, the fabrics division was disposed of as an MBO in 1995, illustrating that such transactions also assist the strategy and performance of the divesting organization (Toms & Wright, 2002). In short, the MBO wave assisted the unlocking of the conglomerate discount, often to the benefit of both parties.

In contrast to the earlier forms of entrepreneurial finance, the new waves of MBOs were a significant financial innovation in their own right. Some aspects, such as participating preferred ordinary shares and structured debt finance, were not new, indeed they had been important features of many industrial and other companies floated in the booms of the late nineteenth century. However, the new legal framework allowing redemption and convertibility, allowed sufficient flexibility to establish strong equity-based incentives, underpinned by tailored incentive-adjusted mezzanine finance (another leading feature of the earlier Gateway example) and covenants linked to performance monitoring mechanisms. Where appropriate, these incentives could also be linked to employee share ownership plans.

These structures also promoted product, organizational, and administrative innovation. MBO structures created an increased probability of new product development, improved customer relations, and offered better control systems and cost control. Taken together, all these innovations led to a revival in entrepreneurial opportunity (Wright et al., 2000). As such, it could be said that the disparate functions of entrepreneurs, product development, finance, company promotion, as traditionally carried out by separate individuals, were effectively institutionalized by the development of MBOs.

United Kingdom/United States comparison

The validity of this conclusion can be supported by a comparison with the experience of the US, which developed buyouts in parallel with the UK, but with some strikingly different features. As noted earlier, US venture funds like CVC had made pioneering investments in the new technology firms of Silicon Valley and had exported their model to Europe and the UK. However, the buyout wave that appeared in the US during the 1980s had some important distinguishing features. Most notably, the characteristics of buyouts along with other features of the US market for corporate control, including excessive litigation and arbitrage, led Baumol (1996) to conclude that this was a period of “unproductive” entrepreneurship. Key features of the US model were that whole companies were bought out, most famously RJR Nabisco by Kohlberg, Kravis, Roberts & Co (KKR), the so-called “Barbarians at the Gate” (Burrough & Helyar, 2010). The KKR case also exemplified a second important feature: the use of (sometimes excessive) leverage, which certainly reached levels much higher than in the UK. Transactions in the US were more frequently contested and hostile, and there was a clearer separation between the buyout and venture capital markets than in the UK, where they rapidly integrated. As a consequence, buyouts in the US have been subject to much more scrutiny from lawmakers (Toms & Wright, 2005).

Before and after the global financial crisis, 2007–2008

Figure 3.1 shows the long-run trend in MBOs and MBIs by number and by value. As the figure shows, from small beginnings in the late 1970s, the number of transactions expanded rapidly up to 1990. In value terms the growth was less pronounced before the mid-1990s and finally peaked in 2007, long after the growth cycle in the number of buyouts had reached
its mature phase. The late 1990s and early 2000s were thus characterized by higher value transactions.

A useful illustration of the emergence of the larger-scale MBO during this period is provided by the beer and pub industry. An important initial reason for the involvement of buyout teams was specific regulation against anti-competitive behavior. Following an investigation in 1989, the Monopolies and Mergers Commission concluded that vertically integrated brewing firms controlled too much of the retail (public house) market. The so-called “beer orders” required them to divest significant proportions of their estates. The MBO was an obvious vehicle for this, and as with the earlier buyout waves, both parties stood to gain. For the large vertically integrated brewers, the MBO provided a ready means to comply with the new legislation and refocus on specific areas of the value chain. The bought-out pub estates were now effectively pub-owning companies (Pubcos), and they recognized that higher market share would increase both their bulk buying power and their ability to control the margins of pub managers. A leading example was Enterprise Inns, a venture capital backed MBI which took over an estate divested by Bass Plc in 1991. To achieve this quickly they sought PE backing. They were assisted by Cinven, an international PE firm, led by Morgan Stanley’s Princes Gate Investors and Legal & General Ventures, thereby facilitating Enterprise’s successful and profitable acquisitions of Unique and Voyager pub groups, whose cash flows were then used to generate securitized loans to finance the Laurel Group’s estate of pubs. Their rationale was that pubs could be bundled together and their cash flow securitized, providing access to cheap debt finance. Risk, meanwhile, could effectively be transferred to pub managers through fixed rent and beer charges (Higgins et al., 2016).

The model worked well for the Pubcos, but at some cost to other stakeholders, including entrepreneurs. As a consequence, they have been subject to scrutiny from parliamentary committees of enquiry, amid claims of abuse of tenants and failures to maintain pubs of community value. To limit the possibility of power abuses, there have been attempts to secure appropriate codes of conduct through legislation.8

Figure 3.1 United Kingdom buyouts and buyins by number and value (£m)
Source: CMBOR/Equistone Partners Europe/Investec.
To some extent the criticisms levelled against PE-backed Pubcos are also valid in terms of the effectiveness of entrepreneurial finance. As noted earlier, the great strength of the MBO/PE model was its institutionalization of the hitherto disparate and individual functions of entrepreneurship. In the beer and pub industry, the entrepreneurial function operated precisely at this meso-level, successfully raising substantial financial resources to transform an industry. The problem, however, was the strangulation of micro-level entrepreneurial initiative. Although it was true that pub landlords had some freedom to innovate under Pubco tenancies, their complaint was that any hint of success would be rewarded with an upward rent revision. As a result, lack of incentive structures, exposure to risk, and lack of control over margins and investment, meant that pub licensees were reduced to custodians of a shrinking and impoverished estate, which Pubcos could continue to exploit through asset sales against a backdrop of rising property values (Higgins et al., 2016). The evidence from the beer industry suggests that the MBO/PE model can only be part of the overall provision of entrepreneurial finance. Free of tie pubs, for example, offer greater scope for entrepreneurship at the micro business level.

More generally, however, there is evidence that the supply of finance into smaller businesses via MBOs has reduced since the late 2000s. The trend in Figure 3.1 shows a decline in the number and value of MBOs following the global financial crisis of 2007–2008. In value terms, there was a very substantial fall from the peak achieved immediately before the crisis of 2007. This downward correction was much more significant and persistent than the aftermath of the dot.com crash of 2001.

Following the financial crisis, MBOs appear no longer to address the equity gap as they once did. In the wider economy, particularly after 2007, and notwithstanding the substantial developments of the preceding three decades, there is evidence of the persistence of the equity gap. Firms located in the London and the South East appear to have less of a problem accessing capital, but smaller peripheral firms face substantial barriers (Rowlands, 2009; Amini et al., 2010; Mason & Harrison, 2015).

Figure 3.2  Trends in PE-backed smaller buyouts and buyins (numbers)
Empirical evidence for smaller firms suggest that the buyout surge that rejuvenated much of UK industry has run out of steam and there were signs of this even before the financial crisis (Figure 3.2). Figure 3.2 shows the number of smaller buyouts backed by PE, but the total value of transactions in these size ranges has also generally fallen (Wilson & Wright, 2017). Investors meanwhile, favor larger sizes, thereby avoiding the relatively high transaction cost of smaller opportunities, whose lack of performance track record also accentuates perceived risk (Rowlands, 2009). Taken together, the trends in Figures 3.1 and 3.2 indicate a peak in smaller, entrepreneurial MBOs in the late 1990s, followed by a shift to higher, larger transactions that sustained growth in value terms up to 2007.

Conclusions

Recent trends in buyout activity beg the question of their future role as investment vehicles capable of sustaining economic growth. If history is any guide, it is clear from the discussion in this chapter that structural changes are perhaps more important than cyclical trends. The structural changes in the early 1980s, including company law reform and the deregulation that facilitated the entry of new financial institutions and innovative financing, were of the utmost importance in energizing the wave of buyout activity that followed. That upsurge was strongly characterized by smaller entrepreneurial buyouts, at least until the peak of the dot.com boom at the end of the 1990s. The cyclical downturn that impacted the wider economy had little effect on the level of buyout activity in value terms. In parts of the economy, like the beer and pub industry, the move to larger transactions stifled entrepreneurship at the micro-business level. More generally the number of PE-backed buyouts for small firms declined significantly from the early 2000s. As in the nineteenth century, the preference of investment funds for larger deals with relatively lower risk and transaction costs, has led to a divergence between entrepreneurial opportunity and financial provision.

The significant consequence of all this then appears to be a return to the long-run problem of the equity gap. Further research is needed to assess how this challenge might be met, for example identifying firms and sectors that can be turned around and how the investment needed can be suitably tailored and incentivized. Such research is of clear practical value in terms of assisting the recovery of previously industrialized regions, as in the case of the UK's so-called "Northern Powerhouse." In conducting such research, the lessons of history are valuable. Certainly, the buyout waves of the 1980s and 1990s offered some interruption of the otherwise persistent problem of the equity gap, particularly for smaller, potentially innovative firms, which has now re-emerged in most sectors and regions following the global financial crisis. A final question therefore is whether the underlying features of the buyout model, explored elsewhere in this book, can once again be adapted to respond to the opportunities and threats of new and challenging economic circumstances.

Notes

2 Using a standard definition of a management buyout: "an acquisition in which the acquiring group is led by the company's own management and executives" Financial Times, http://lexicon.ft.com/Term?term=management-buy_out-(MBO).
3 British Parliamentary Papers, Committee on Finance and Industry (Macmillan Committee): Report of Committee (Cmd. 3897), 1931.
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5 For further examples of these developments, see: “Citicorp opens new European investment unit” Financial Times, March 7, 1974: 24; On a slow boat from America, The Economist, January 3, 1987: 5.

References
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