Leverage and The Performance of Buyouts: (How) Does The Use of Debt Impact Equity Returns?

Abstract:
In this paper we investigate the effects of debt usage on (risk adjusted) equity returns in private equity-backed buyout transactions. We use a proprietary data set of more than 700 realized European and North American buyouts acquired between 1990 and 2006 to empirically assess theoretical predictions. Our results show a positive relationship between debt levels and equity returns indicating the return-enhancing effects related to leverage. However, our results also provide evidence that it is possible to ‘over-leverage’ a company, i.e. at very high levels of leverage (debt to total capital of approximately 90%) the increased company default risk outweighs the positive effects related to leverage resulting in decreasing equity returns. On the other side, we find no significant relationship between leverage and risk-adjusted equity returns which implies that the return increase through higher debt ratios comes along with increasing risk. In addition, we show that private equity sponsors successfully conduct debt-equity-arbitrage in times of favorable debt market conditions. This implies that these
investors successfully time debt markets.

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