WHAT INFLUENCES INVESTORS' PERCEPTIONS OF PRIVATE EQUITY FIRM WINDOW DRESSING AT IPO?

Authors: Donald G. Ross
         Mike Hopkins

Correspondence to:

Donald G. Ross, Ph.D.
Macquarie Graduate School of Management
Macquarie University
Macquarie Park, NSW 2109   AUSTRALIA
Tel: +61 2 9850 8989
Fax: +61 2 9850 9019
Email: Donald.Ross@mgsm.edu.au
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ABSTRACT

Fear of private equity firms “putting lipstick on the pig” when presenting investee companies to public markets is common in the IPO investor market. Private equity firms wish to maximise their exit value and, indeed, have a fiduciary duty to their Limited Partners to do so. Accordingly, they maximise their exit values by showcasing investee companies in the best possible light when presenting them to investors at IPO. While private equity firms are thought to add considerable value to investee companies through their enhanced access to resources and improved corporate governance, not all private equity activities at IPO are considered to have lasting positive effects. Substantial concerns have been voiced over cash stripping, accounting manipulation and short-term cost cutting to maximise reported profits. This paper presents findings related to the window dressing phenomenon which have been drawn from a larger study into private equity certification of investee companies at IPO. This study used a mixed method approach of a judgement experiment combined with qualitative interviews with buy-side financial analysts to investigate how the characteristics of the private equity firm and its involvement with the investee company influence IPO investors’ decision making. The results of the research confirm buy-side analyst concerns over window dressing to be real and exacerbated by evidence of intense private equity firm involvement over short durations of time. Concerns can be mitigated, however, by positive signals of future prospects, notably the degree of retained ownership and perceived quality of the private equity firm, itself judged by the track records of previous IPOs.
INTRODUCTION

“One of the skills that myself or any other of my peers in the industry require to be good at this game is to have a good bullshit filter.” Buy-side financial analysts – such as the one just quoted – need to be able to separate substance from spin when deciding the value of IPOs coming into the market. This concern over spin and window-dressing is particularly acute in the case of private equity firm divestures through IPOs.

Window dressing of an investee company for IPO will involve actions on the part of the private equity firm that are superficial and do not lead to sustainable benefit. Previous, and somewhat conflicting, studies have suggested that window dressing is practised by private equity firms (Chou et al, 2006), that private equity firm involvement is not influential (Teoh et al, 1998) and that private equity firm involvement can mitigate such practices (Jain & Kini, 1995; Morsfield & Tan, 2006).

The study of private equity firm window dressing at IPO is inherently linked with the market’s perception of private equity firms’ perceived roles and the added value of their involvement in their investee companies. While the added value practices – manifested in certification effects – of private equity firms have been extensively studied, these practices have rarely been addressed from the perspective of market participants. This paper – part of a larger study into buy-side financial analyst perceptions of contributors to private equity certification of investee companies at IPO – investigates the analysts’ perceptions of window dressing in private equity backed IPOs and in particular whether certain characteristics of private equity involvement, or combinations of characteristics, are of particular concern.

In studying the influence of private equity firms it is important to be specific about what the market considers to be under the influence of private equity firms and what is not. While previous studies of window dressing have tended to focus on the manipulation of earnings or accruals (e.g. Stein, 1989; Teoh, Welch, & Wong, 1998), this study uses a broader definition developed from discussions with market participants which includes other items which the market considers to be relevant in assessing private equity backed IPOs. These discussions suggest that the marketing

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1 Consistent with recent practice the term private equity includes early stage, venture capital focused firms as well as later stage, expansion and buyout focused firms (Megginson, 2004).
and promotion of IPOs is very much the remit of brokers, with limited involvement from private equity firms. Private equity firms are, however, considered to be highly influential in preparing businesses for presentation to the market. This includes their financial structuring, strategy development, record of acquisitions and disposals and the composition of board and management teams. They are also considered highly influential in determining the timing of IPOs, ordinarily to attempt to coincide them with hot markets.

The paper proceeds with a review of the private equity firm certification literature and the research model used to guide the larger study. A summary of the mixed method approach used, namely a judgement experiment and in-depth interviewing, is then presented. Evidence of buy-side analyst concerns over window dressing by private equity firms as drawn from the mixed methods is then presented. The paper finishes with a summary of these findings and the conclusions that can be drawn from this study to provide a fresh, market orientated perspective to the issue of private equity firm certification and window dressing.

LITERATURE REVIEW

The literature sets out four key stages during which private equity firm involvement could add value to an investee company exited through an IPO. These are: (1) screening and evaluation processes which identify better prospects, (2) governance and mentoring activities which nurture investee companies and prepare them for life as a public company, (3) private equity firms’ knowledge and networks which add value around the IPO event, and (4) continued involvement which contributes to superior post IPO performance.

First, it has been argued that private equity firms begin to add value to their investee companies even before the initial investment takes place through considered evaluation and selection procedures. These procedures identify only the best prospects for investment (Fried & Hisrich, 1994; Hall & Hofer, 1993; Hisrich & Jankowicz, 1990; MacMillan, Siegel, & Subbanarasi, 1985; Tyebjee & Bruno, 1984) and together with the imposition of governance and monitoring controls in investment contracts (Gompers, 1995; Sahlman, 1990) lead to enhanced prospects of survival and prosperity.

Second, private equity firms have been described as active investors, monitoring the progress of firms, sitting on boards of directors, and meting out financing based on
the attainment of milestones (Gompers & Lerner, 1998). This active investor role is demonstrated by buyout focused firms as well as earlier stage ‘venture capital’ firms (Cao & Lerner, 2009; Cornelli & Karakas, 2008; Cotter & Peck, 2001). The ways and means through which private equity firms are posited as potentially adding value to investee companies are myriad. Frequently cited ways include: “1) assistance in finding and selecting key management team personnel; 2) solicitation of essential suppliers and customers; 3) strategic planning; 4) assistance in obtaining additional financing; 5) operational planning; and 6) replacement of management personnel when appropriate” (MacMillan, Kulow, & Khoilian, 1988, p. 28; . Private equity firm involvement has also been shown to be associated with efficiency and productivity improvements, both in respect of buyout specialists and venture capital firms (Chemmanur, Krishnan, & Nandy, 2009; Cotter & Peck, 2001; Cressy, Munari, & Malipiero, 2007; Munari, Cressy, & Malipiero, 2006). One of the key areas of interaction between private equity firms and investees is through participation on investee company boards. Private equity firms ordinarily require board representation as part of their funding agreement (Beecroft, 1994; Cotter & Peck, 2001; Kaplan, 1989; Sahlman, 1990). Private equity firm representation on boards has been found to increase as the investee company moves through its developmental phases and staged investment increases the ownership level of the private equity firm (Smith, 2005).

Third, private equity firms are believed to add value around the IPO event. Their familiarity with the process enables them to prepare the investee company beforehand, for example by influencing marketing and R&D expenditure to portray an appropriate balance of investment for the future and current profit. They may also impose appropriate governance and management structures to make the offer attractive to future shareholders (Campbell & Frye, 2006; Krishnan, Masulis, Ivanov, & Singh, 2009). Through these preparatory actions, a more attractive proposition is presented to the market, thereby achieving a higher price and/or hastening the time to IPO (Barry, Muscarella, Peavy, & Vetsuypens, 1990; Dolvin & Pyles, 2006; DuCharme, Malatesta, & Sefcik, 2001; Lin & Smith, 1998; Sandström & Westerholm, 2003; Timmons & Bygrave, 1986; Wang, Wang, & Lu, 2002). Further, private equity firm experience with the IPO process and markets can deliver a timing benefit (Lerner, 1994). Timing of an IPO to coincide with positive market conditions is a key consideration in going public and is associated with higher returns (Cumming, 2008; Lerner, 1994; Ritter & Welch, 2002). Experienced private equity firms have been shown to be better at timing IPO exits (Lerner, 1994) and less incentivised to take investee companies public for ulterior motives as can be the case with younger
venture capital firms who may wish to generate reputational benefits (Gompers, 1996). Finally, private equity firms’ contacts within the industry can not only lead to the selection of superior service providers of associated functions, e.g. auditors, lawyers and underwriters, but can also reduce the costs of evaluating, selecting and commissioning these service providers (Bygrave & Timmons, 1992; Dolvin, 2005; Dolvin & Pyles, 2006; Stein & Bygrave, 1990).

Fourthly, private equity firms can continue to add value beyond the IPO. They commonly retain high degrees of ownership (Barry et al, 1990; Bradley, Jordan, Yi, & Roten, 2001; Brav & Gompers, 1997; Cao & Lerner, 2009; DeGeorge & Zeckhauser, 1993; Holthausen & Larcker, 1996; Lin & Smith, 1998; Mian & Rosenfeld, 1993). Consequently, their board representation and influence continues after the IPO event (Campbell & Frye, 2006; Jain & Kini, 1995; Krishnan et al, 2009), which is not ordinarily the case under other exit routes (Wright et al, 1990).

Collectively, these value adding activities of private equity firms are considered to have lasting benefit for investee companies. An extensive study of post IPO performance by Brav & Gompers (1997) suggests that the knowledge, resource and network benefits private equity firms bring extends beyond the event of going public. In comparing post IPO share price performance, their sample of private equity backed firms significantly outperformed non-private equity backed firms despite being smaller, as measured by market capitalisation.

Conversely, buy-side analysts need to be concerned that leaner operations together with reduced capital expenditures (see Fox & Marcus, 1992; Kaplan, 1989) will lead to a lack of sustainability following the IPO. Window dressing is therefore an important aspect of private equity firm behaviour which needs examination. However, given the expansive literature into private equity firm certification of investee firms, there is – by comparison – relatively little, directly related work on window dressing. In the case of reverse LBOs, accounting measures of operating performance have been found to peak around the time of the IPO (DeGeorge & Zeckhauser, 1993). Existing evidence is mixed as to whether this extends to manipulating reported performance to window dress public offerings. On one hand, the presence of private equity firms, other than young, inexperienced firms, has been found to mitigate the management of accruals (Jain & Kini, 1995; Morsfield & Tan, 2006). In contrast, Chou, Gombola & Liu (2006) found evidence of significant discretionary accruals around the IPOs of reverse LBOs.
RESEARCH MODEL

The above studies into value adding activities of private equity firms enables a conceptual framework to be grounded in theories of resource dependence and exchange (Pfeffer & Salancik, 1978), agency risk (Jensen & Meckling, 1976), and informational asymmetry (Akerlof, 1970), including certification theory (Booth & Smith, 1986). More particularly, the research model posits that private equity firm inputs of their network, knowledge and time resources are assessed by buy-side financial analysts in terms of their levels of intensity of involvement, duration of involvement, on-going commitment, and firm reputation at time of IPO. This assessment leads to a summary judgement of private equity firm added value as perceived by the market, synonymous with a certification benefit, that influences the attractiveness of private equity backed IPOs (Beatty & Ritter, 1986; Booth & Smith, 1986).

Each of the model’s posited three types of resources can impart substantial value to the private equity firm’s investee companies. Network resources derive from the social capital of private equity firms and include their networks and contacts with suppliers, customers and professional advisers including accountants, lawyers, underwriters and industry specialists who can frequently act as consultants or board representatives. The extent and quality of network resources will have a direct influence over a private equity firm’s reputation in the market and will influence the performance of the investee company over the course of their relationship depending on the amount of time the private equity firm dedicates to the firm. Knowledge resources derive from the technical, industry and managerial knowledge and experience of the private equity firm and its knowledge and experience of the IPO process. The extent and quality of knowledge resources will have a direct influence over a private equity firm’s reputation in the market and will influence the performance of the venture depending on the amount of time the private equity firm dedicates to the investee company. The time resource is, therefore, a critical conduit through which other resources are applied (Balboa & Marti, 2007; Kanniainen & Keuschnigg, 2003; van Osnabrugge & Robinson, 2001) and the amount and frequency of contact with investees has been shown to be positively associated with measures of performance (e.g. Cumming & Walz, 2009; Gabrielsson & Huse, 2002; Sapienza, 1992; Sapienza & Timmons, 1989).
METHODOLOGY

This paper uses a mixed methodology approach comprising a factorial experiment along with in-depth interviewing. The use of a mixed methodology is common in business research (Collis & Hussey, 2003) and the combining of qualitative and quantitative techniques delivers considerable complementarities including triangulation, completeness, credibility, enhanced explanatory power and context (Bryman, 2006a, 2006b; Greene, Caracelli, & Graham, 1989; Patton, 1990; Yin, 2003).

The interaction effects consistent with buy-side analysts’ concerns over window dressing were generated through a deductive process using an experimental technique adapted from the early works of Slovic and others (Slovic, 1969; Slovic, Fleissner, & Bauman, 1972). This experimental approach delivers the key benefit of evidencing causality rather than simply a correlational association (Coolican, 2004; Keppel, 1982). Concurrently, interviews were conducted with eight buy-side analysts to deliver rich, contextual data (Bryman, 1988; Creswell, 1998; Patton, 1990). Data from both elements of the study were integrated at the interpretation phase which enhances the confidence attributable to inferences of causality and the reliability of conclusions (Bryman, 1992; Creswell, 2003; Shadish, Cook, & Campbell, 2002).

The choice of buy-side financial analysts as the unit of analysis enables an understanding of the motives and actions of individuals who have daily involvement in the IPO assessment and valuation process from their own perspective (Creswell, 1998, 2003; Patton, 1990). As such, interviews with analysts on the topic of private equity firm certification is, therefore, akin to the expert interview, as described by Flick (2002). Further, analysts’ views and reports are valued in the marketplace and have a material influence in the determination of closing market prices on the day of an IPO’s issue (Bouwman et al, 1987; O’Brien & Bhushan, 1990; Schipper, 1991). Indeed, Schipper (1991) suggested studies of the perceptions and behaviours of analysts can deliver valuable insight into investor behaviour as a whole (see also Trueman, 1994; Welch, 2000). As recommended by Maines (1995), experienced analysts were targeted to increase the validity of findings.

Data for the experimental treatments were collected from 30 Australia-based, buy-side financial analysts. The 30 completed responses sits at the top end of Coolican’s (1994) recommended optimum range (25-30) for studies of homogeneous respondents for repeated measures designs. The eight interviews with buy-side
financial analysts were conducted between October 2008 and April 2009. All interviews were face-to-face, conducted at the workplaces of interviewees and followed an interview protocol for consistency. Both the survey instrument and protocol were pretested.

**FINDINGS**

The key experimental evidence of window dressing concerns is a large, significant interaction effect which accounts for 11% of the total effect sizes of the independent variables presented in the Research Model. It reveals intensity of involvement, when considered interactively with the duration of involvement, to be a relevant factor to financial analysts determining the attractiveness of a private equity investee firm’s IPO. This interaction is illustrated in Figure 2, which demonstrates that where intensity of private equity involvement is low, differences in the duration of involvement have only a modest impact on the attractiveness of the IPO, suggesting little value is being added. The picture for high intensities of involvement is very different. When the intensity of involvement is high and is associated with a low duration of involvement the IPO is considerably less attractive. However, when the duration is also high the IPO is considerably more attractive and is more attractive than the high duration/low intensity combination. This suggests the relative attractiveness of the IPO can flip depending on the combinations of these factors with a high intensity/low duration combination – the combination that would most typically be associated with window dressing – being especially unattractive. Another way of looking at this result is that high intensities of involvement are only perceived as adding sustainable value when delivered over a longer period, otherwise they are perceived as window dressing.

***Figure 2 here***

Interview results confirm this phenomenon with clear concerns voiced by the buy-side analysts over window dressing by private equity firms, especially in respect of short durations of involvement.

Preparation of the company for listing is seen as one of the main objectives of private equity firms. Accordingly, involvement with this intent is believed to drive decision making throughout the duration of involvement. Comments specifically related to
preparation for the IPO\(^3\) illustrate how these items combine to present a more attractive proposition to the market and several are included below for illustration:

“A private equity firm’s primary motivation is to sell the firm at more than they bought it for with a return of 25% on equity. What that means is they will do what changes are necessary to make the firm look good for a short period of time in whatever their holding period is, 5 years, 3 years and sometimes that’s going to be lasting, good changes and sometimes that’s going to be, you know, cosmetic changes.”

Subject A

“A lot of it is dressing up the beast to make it look more saleable for IPO time and that can involve building up the cash flow by cutting capital expenditure and cutting maintenance costs. …… Let’s face it, this is a marketing programme. They’re probably more interested in what sells to the IPO buyer, so they’ll probably want to make sure that the package shines up pretty well. We had an expression in [former employer’s name omitted for confidentiality] called putting lipstick on the pig and when the product is a pig they go to great lengths to put lipstick on it. So what do you do, you get a Chairman who’s a big name, you get a bit of publicity, if you’re in the clothing industry you get catwalk models and have a show, you attach names and you try and make the numbers look as rosy as possible.”

Subject C

“There’s a bit of an element of them being packaged up because they know key boxes that investors need to tick when they look at IPOs.”

Subject G

Consistent with the findings of the experiment, concerns over private equity involvement are heightened where the duration of involvement is short as noted:

“Even if the change has been great if the time has been long enough where it’s been operating, I would trust it, that the company has that internalised. … If the change has been great and the time short then, obviously, I’d be worried.”

Subject A

\(^3\) This packaging of the IPO does not extend to influence over the visual presentation of the prospectus or to presentations to potential investors. These activities in respect of marketing the IPO were seen as the domain of the broker. The main concern of analysts is to assess how significant and enduring any changes are and how substantial and sustainable the benefits they deliver.
“If the PE firm was into something and then after 2 years was looking to move it on, that would create suspicion.”

Subject C

“The obvious question when buying from PE is, what did you buy it for? If you bought it two years ago for $100 million and now you’re trying to sell for $1bn in two years, how have you created that value in two years or is it just thin air and smoke and mirrors?”

Subject G

Notwithstanding these concerns, the degree of retained ownership and perceived quality of the private equity firm can act to signal the quality of the IPO and provide reassurance to the market. Retained ownership at IPO is overwhelmingly seen as a positive influence on the attractiveness of private equity backed IPOs, even where expectations of the post IPO holding duration are modest as evidenced by the following:

“In the hypothetical scenario where they have a stake in, the price they receive is partially escrowed to the performance they’re going to produce in the next 2 or 3 years, yeah, that mitigates risk.”

Subject A

“People like to see them have a shareholding left over. It gives investors some sort of confidence that they’re not walking away. ..... People probably anticipate that that probably won’t last for too long. A few years down the track that will probably go as well. But if the business is going well the market doesn’t have any problem with that.”

Subject C

“If they’re saying they’re floating the business but we’re keeping 90% of our shareholding, then that's probably a good sign.”

Subject F

“That gives you more confidence if they’re retaining a meaningful stake that there are [better prospects] of the ability of the company to perform.”

Subject G

“I find it slightly more attractive if there is some continuity of investment. ..... It's a signal to us that they still see some degree of value in there.”
The most consistently cited determinant of private equity firm reputations among analysts are the track records of previously floated investee companies.

“[Track record] of having brought a number of stocks to the market that have proven to be quite successful in terms of operationally and in terms of, by implication, ultimately share price performance.”

Subject D

“Track record ….. the successful completion of lots of ……. not dud IPOs. Track record is everything they’ve bought and sold and how it’s gone over time.”

Subject A

“Reputation, if someone’s done a dud of a deal, it's a pretty small market the institutions, it doesn't matter how much funds are actually invested, you’re still talking, most people know each other in terms of the institutional side.”

Subject B

**SUMMARY AND CONCLUSION**

It is clear that the market views private equity firm involvement as typically targeting a maximisation of value to the private equity firm (including revenue from the IPO and pre IPO dividends) at the IPO even to the detriment of long term sustainability, as suggested by Fox & Marcus (1992). As such, window dressing is a real concern of buy-side analysts. The experimental results suggest that the primary conditions under which window dressing is most feared by buy-side analysts are private equity backed IPOs characterised by high intensity and short durations of private equity involvement. This finding is consistent with interview comments. While interviewees were suspicious of all private equity backed IPOs, this scepticism was higher for shorter durations of involvement. There was some suggestion from the interviews that longer periods of involvement were also perceived negatively, perhaps suggesting a non linear relationship. This possibility warrants further investigation.

Concerns over private equity firm window dressing of their investee companies at IPO can be mitigated by the level of private equity firm retained ownership. This is particularly so as the level of retained ownership was consistently mentioned in the interviews as a risk reduction signal through reducing informational asymmetries –
that is, by conveying to the market that the vendors have continuing confidence in the company. Likewise, window dressing concerns were also alleviated by the perceived quality of the private equity firm, as indicated by their track record of previous IPOs.

Buy-side analysts are suspicious of private equity backed IPOs and require reassurance that they will deliver sustainable added value. This paper's findings establishing the conditions under which analysts most fear window dressing and how these concerns can be mitigated should be of interest to both investors in private equity firm IPOs and private equity practitioners who will be better placed to address market concerns over informational asymmetry and transparency.


Figure 1
Research Model

PE Firm Inputs

Assessable Inputs (at IPO)

Perceived Outputs/Certification

Resources

Supplier networks
Customer networks
Professional networks
VC experience
Industry & technical expertise
Managerial expertise

Network resources
Time resources
Knowledge resources

Intensity of involvement
(Historic) Duration of involvement
Ongoing commitment
Perceived quality of PE firm

Perceived added value
= Certification benefit

Figure 2
Interaction Of Intensity And Duration Of Private Equity Firm Involvement In The Attractiveness Of IPOs

Estimated Marginal Means

Intensity of involvement
Low
High

Duration of Involvement

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