

GOING PRIVATE TRANSACTION AND SOURCES OF RETURNS

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Abstract

There is recent spate of going private transactions in Malaysian stock market. This paper seeks to provide answers to investors about the puzzling wealth gains. We analyze stock price reactions prior and after the going private announcement and investigate the sources of stockholder returns. The finding indicates that there is positive returns surrounding the buyout proposals and these abnormal gains can be explained by financial leverage, dividend payout, growth prospect, insider holding, market-to-book value ratio, outcome of the proposal, return on total asset, and Tobin's q ratio for 79 firms which went private for the period 2001-2007.

Keywords: Going private; Stock market.

JEL Classification Codes: G34.

1. Introduction

The life cycle of a company starts from a closely held entity. After the business expands, the owners seek to list their firms on stock exchange in order to enjoy the various benefits of public incorporation, for instances the presence of objective appraisal mechanism provided by market, wealth diversification with liquid portfolio, and ability to raise capital in equity market. The question then arises as to why these firms engage in public-to- private deals despite of numerous benefits of public incorporation.

The going private transaction appears to be the use of market timing techniques on company asset which usually applied to stock. Going private activity is described as a process of door policy "a process of in in good times and out in bad times". Insider managers who hold private information about the company decides when to exit and enter capital market (Ainina and Mohan, 1991).

Shareholders receive large offer premiums relative to pre-offer market values surrounding going private announcement (DeAngelo et al., 1984; Grammatikos and Swary, 1986; Travlos and Cornett, 1990). However, some argue that going private represents a corporate reorganization and it does not create value. Does public-to-private deal has positive impact on the target firm's production capacity and create social wealth or it merely inflating stock value unjustifiably? Previous researches examine several hypotheses that serve to explain premium to target shareholders but there is no precise sources of gain.

Given the significant returns reported in UK and European Countries, it is important to assess the extent to which these shareholder wealth gains can be replicated by Malaysia going private cases. This study analyzes stock price reactions prior and after the going private announcements and investigates the sources of stockholder returns. The paper is organized as follows: Section 2 is literature review followed by data and methodology in Section 3. Section 4 is the empirical results and the last section summarizes the main findings.

2. Literature review

Gains from going private transaction

Brown et al. (1988) proposed that stock return variability will increase following an unanticipated announcement under uncertain information hypothesis. Market respond to incomplete information and this new information affect expected payoff and possible outcome of a security. Investors' anticipation of future benefits will reflect in participating firm's market price when acquisition is announced.

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DeAngelo et al. (1984) investigate the motivation and sources of shareholder wealth gains from a sample of 72 firms between 1973 and 1980. From the finding, the average cumulative abnormal returns for 40 days prior to going private announcement through initial announcement date, [-40; 0], is 30.40%. Lehn and Poulsen (1989), using 257 buyout proposals, report 36.1% of average abnormal returns 20 days preceding the announcement through the final price at which the stock is traded on the market for the period studied (1980-1987).

In spite of the strong evidence of abnormal returns accruing to target shareholders. Briston et al. (1992) find negative abnormal returns upon the MBO announcements. It is interesting to study the announcement effects on stock prices and the sources of these abnormal returns.

Sources of shareholder wealth gains

Undervaluation. Under asymmetric information, managers may know the asset's return distribution better than its owner. When market is inefficient, the share price does not reflect its true value. Andres et al. (2004) find that target firms which are more undervalued than its peer group accrue higher abnormal return to shareholders. Renneboog et al. (2005) also state that one the main sources of shareholder gains upon going private transaction is share undervaluation.

Insider ownership. Public corporation is characterized as having highly dispersed ownership with managers own insignificant equity of the firm. The pitfall of diffuse ownership structure is managers are incentivised to shirk their effort and use their time on other tasks and indulgencies, which reduce the company performance. By going private, all the benefits and costs are borne by the sole owner. Managerial ownership acts as an incentive to align interest between managers and owners. More ownership in the hands of managers will lead to greater equity value (Jensen and Meckling, 1976). Under the aligned-interest hypotheses, managerial stake is negatively related to abnormal returns to target shareholders. Stulz et al. (1990) provided some evidence for the linkage of target's abnormal return and managerial ownership. They find target shareholder wealth increases with higher managerial ownership in successful, contested bid. Their results suggest that managerial holding is positively related to target shareholder wealth in contested cases which are ultimately successful. Shareholder returns is significantly increase when management use their shares to resist and negotiate, but not to block an acquisition. In contrast, Grammatikos and Swary (1986) find a negative relationship between prior managerial shareholdings and abnormal return. On the other hand, Travlos and Cornett (1990) suggest there is no significant relationship between stock return and managerial stake.

Method of payment. The form of financing provides a signal which is unrelated to acquisition (Asquith et al., 1987; Franks et al., 1988). The signalling hypothesis suggest that cash offer to the target firm signals positive information about bidder's firm since cash payment allowed the current shareholders to retain all the future returns. On the contrary, stock exchange signals negative information as existing shareholders would have to share future returns with new shareholders (Seyhun, 1990). The signalling model predicts that managers prefer cash offer if they believe that the firm is undervalued and stock exchange is preferable in opposite case (Leland and Pyle, 1977; Myers and Majluf, 1984). Higher premium and CARs is expected for cash transaction is supported by empirical evidence (Huang and Walkling, 1987; Smith and Amoako-Adu, 1992).

Financial leverage. In Kim and Lyn's (1991) and Carow and Roden's (1997) studies, they find that the greater the leverage, the lower is the returns from leveraged buyouts. Firms that are currently not employed financial leverage to optimum level have more to gain in going private transaction. Besides, increases in financial leverage convey positive expectation of management towards the firm's future prospect. Low value firms cannot afford to give wrong signal to outside shareholders, thus capital structure decision associated with financial leverage increases serve as valid signals that managers have superior information relative to investor (Ross, 1977; Leland and Pyle, 1977).

Firm size. The possibility for small firms to convey information to investors is limited due to lack of interest from financial analysts and inadequate coverage of financial press. Information is not reflected in the share prices due to stock illiquidity and low trading volume. Upon going private announcement, all information is incorporated and reflected in share prices due to increase in public interest.

Free float. Abnormal returns are higher for firms with highly dispersed shareholders when outside monitoring is reduced (Andres et al., 2004). Andres et al. (2007) , in examining shareholder wealth effect for a heterogeneous sample of 115 buyouts during the period from 1997 to 2005, find that companies with high free float and thus lower monitoring, generate higher abnormal returns upon going private. Stock price is higher for companies with scattered shareholdings because greater efficiency improvement due to closer monitoring by concentrated shareholders after buyout transactions. Incentive realignment of managers and owners and better monitoring mechanism create value to shareholders.

Inefficient management. The inefficient management hypothesis argues that poorly performed firms should produce abnormal gains when inefficient management are replaced. These companies are more affordable as acquisition targets. The larger is the departure of target firm from value maximization, the greater the potential gains to the bidder. Thomsen and Vinten (2006) provide support for the failing firm hypothesis. Controlling shareholder or outside entrepreneurs may take the poorly performing companies private and restructure the firm.

Dividend policy. There is debate with respect to whether dividend is an appropriate way to align interest between managers and shareholders. Modigliani and Miller (1963) declared dividend policy is irrelevant because investors can home brew their dividends by borrowing or selling against their portfolios. High dividend payment results in lower retained earnings and capital gains, and leave the shareholder wealth remain the same. Agency theory moves away Modigliani and Miller's assumption. Investment policy cannot be treated independently from dividend policy. Agency cost of free cash flow theory argue that excess cash that do not paid out as dividends to outside shareholders will be wasted by managers on organizational inefficiencies. Therefore, in a world with severe agency problem, dividend can serve to disgorge the corporate earnings to shareholders to avoid spending on managerial consumption.

Free cash flow and growth prospect. The most widely accepted view in explaining leveraged buyout is agency cost of free cash flow proposed by Jensen (1986). To motivate managers to run a leaner organization, firms turn to private ownership. Generally, firms in mature industry have large internally generated fund that is idle due to limited investment opportunities. These firms are characterized as low sales growth with excess cash flow. Whilst, companies in high growth sectors are unlikely to go private as they need cash to fund investment projects. High growth firms are better monitored by capital market. In a study conducted in Australia, Evans et al. (2005) contend that buyout targets have low growth.

3. Data and methodology

Data

We identified sample companies from Bursa Malaysia corporate announcement. The event date is the first announcement posted on Bursa Malaysia which published the intention of target firms to delist from stock exchange. After excluding firms with missing financial data, 79 sample firms are identified from year 2000 to 2007. Share prices are obtained through K1setracker, an independent equities research portal, *Daily Diary* published by Kuala Lumpur Stock Exchange, newspapers and Datastream. We extract financial figures and shareholdings statistics from company annual reports, K1setracker and Datastream.

Abnormal returns

All successful and unsuccessful buyouts are included in estimating the abnormal returns because if unsuccessful bid is ignored, valuable information about the ability of a firm to attract a bid may be lost. The technique used to measure abnormal returns around the announcement is the event study described in Brown and Warner (1985). We estimate the abnormal return 20 trading days prior to going private announcement through 20 days after the event day (20 days is approximately equals to one trading month). Abnormal returns are calculated as

$$AR_{i,t} = R_{i,t} - RM_t \quad (1)$$

where $R_{i,t}$ is the return for firm i at day t , RM_t is the return on the Kuala Lumpur Composite Index (KLCI). Correspondingly, cumulative abnormal returns for firm i is given as

$$CAR_{i,T} = \sum_{n=-20}^T AR_{i,n} \quad (2)$$

where T is the length of the event windows.

Explaining sources of abnormal return

In this section, we test abnormal returns accrue to stockholders upon the going private announcement. We define our model as follow:

$$AR(+1)_i = \beta_0 + \beta_1 DEBT2TA_i + \beta_2 DIVPAYOUT_i + \beta_3 GROWTH_i + \beta_4 INSIDER_i + \beta_5 MB_i + \beta_6 OUTCOME_i + \beta_7 ROA_i + \beta_8 TOBINQ_i + \beta_9 D1_i + \beta_{10} D2_i + \beta_{11} TA_i + \varepsilon_i \quad (3)$$

where $AR(+1)$ = abnormal return one day after the announcement; $DEBT2TA$ = total debt/total asset, $DIVPAYOUT$ = dividend per share/earnings per share, $GROWTH = 1 - (\text{net tangible assets}/\text{market value of equity})$, $INSIDER$ = beneficial interest attributable to board of director/total ordinary shares, MB = market value per share/book value per share, $OUTCOME$ = dummy variable proxy for the outcome of the going private proposal (1 if successful, zero otherwise), ROA = net income/total asset; $TOBINQ$ = (book value of debt +market value of equity)/book value of total asset, $D1$ is dummy variable (equal to 1 for cash; 0 for others), $D2$ is dummy variable (1 for stock, 0 otherwise), TA = total asset.

4. Results

Abnormal returns

From Table 1, positive cumulative abnormal returns started from 12 days prior to the announcement and become more evident as it progresses to announcement day. Significant abnormal gains prior to the announcement imply that there is information leakage about upcoming going private announcement. Abnormal return 1.81% is recorded one day prior to the event day. Turning to the announcement day, shareholders earned 2.06% average abnormal return. Besides, extraordinary significant abnormal return of 8.04% is documented the next day after the buyout announcements. The cumulative average abnormal returns for 41 days are 17.69%. Positive stock reaction is consistent with previous studies (DeAngelo et al., 1984; Travlos and Cornett, 1990).

4.2 Explaining Abnormal Returns

We use average abnormal return one day after announcement ($AR+1$) as dependent variable when we run cross sectional regressions of model (3) owing to the fact that most of the firms were suspended on the day of announcement, therefore one day after the announcement is more appropriate to capture the effect of the buyout event.

Results of cross sectional analysis shows that insider ownership is found to have negative significant relationship with abnormal returns. It indicates that lower managerial ownership lead to higher stockholder returns upon buyout announcement. The results shown in Table 2 confirms the aligned interest hypothesis which stated that going private transaction initiated by management eliminate agency problem between shareholders and managers. The separation of control and ownership does not exist after MBOs. Therefore, the expectation of better performance post-buyout causes share price increases.

Table 1: Daily average abnormal returns and cumulative abnormal returns from 20 days before through 20 days after the announcement

| Days relative to announcement | Daily average abnormal returns (AR) in % | T-value | % of firms with positive abnormal returns | Cumulative daily average abnormal returns (CAR) in % |
|-------------------------------|--|-----------|---|--|
| -20 | -0.0183 | -0.0590 | 34.1772 | -0.0183 |
| -19 | -0.1234 | -0.3492 | 40.5063 | -0.1416 |
| -18 | -0.1185 | -0.3570 | 56.9620 | -0.2601 |
| -17 | 0.2616 | 0.9570 | 48.1013 | 0.0015 |
| -16 | 0.0305 | 0.1149 | 36.7089 | 0.0320 |
| -15 | -0.0390 | -0.0968 | 35.4430 | -0.0071 |
| -14 | 0.0104 | 0.0421 | 50.6329 | 0.0033 |
| -13 | 0.1732 | 0.6393 | 51.8987 | 0.1766 |
| -12 | 0.9329 | 2.2242** | 58.2278 | 1.1094 |
| -11 | 0.3305 | 0.8133 | 44.3038 | 1.4399 |
| -10 | 0.2469 | 0.7930 | 50.6329 | 1.6868 |
| -9 | 0.1929 | 0.6470 | 44.3038 | 1.8797 |
| -8 | 0.4011 | 1.2314 | 48.1013 | 2.2808 |
| -7 | -0.2896 | -1.1705 | 40.5063 | 1.9911 |
| -6 | 0.7252 | 1.9075* | 49.3671 | 2.7163 |
| -5 | 0.8427 | 1.9112* | 54.4304 | 3.5590 |
| -4 | 0.7578 | 2.6142** | 64.5570 | 4.3167 |
| -3 | 1.0278 | 3.2133*** | 62.0253 | 5.3445 |
| -2 | 0.3267 | 0.6197 | 54.4304 | 5.6712 |
| -1 | 1.8139 | 2.9241*** | 56.9620 | 7.4851 |
| Announcement Date | 2.0571 | 2.7974*** | 34.1772 | 9.5422 |
| 1 | 8.0362 | 5.6237*** | 82.2785 | 17.5784 |
| 2 | 0.4337 | 1.1031 | 44.3038 | 17.6608 |
| 3 | -0.3513 | -1.4945 | 43.0380 | 17.6608 |
| 4 | -0.4223 | -2.1185** | 41.7722 | 17.2385 |
| 5 | -0.2631 | -1.7123* | 39.2405 | 16.9754 |
| 6 | -0.1226 | -0.4682 | 44.3038 | 16.8528 |
| 7 | 0.7716 | 1.9906** | 48.1013 | 17.6244 |
| 8 | -0.0274 | -0.1652 | 53.1646 | 17.5970 |
| 9 | -0.1810 | -0.8801 | 37.9747 | 17.4161 |
| 10 | 0.2088 | 1.2120 | 50.6329 | 17.6249 |
| 11 | -0.1453 | -0.6727 | 48.1013 | 17.4796 |
| 12 | 0.0246 | 0.1125 | 49.3671 | 17.5042 |
| 13 | -0.0795 | -0.5234 | 51.8987 | 17.4247 |
| 14 | -0.0439 | -0.2320 | 51.8987 | 17.3808 |
| 15 | 0.1191 | 0.6718 | 51.8987 | 17.4998 |
| 16 | -0.1271 | -0.8213 | 46.8354 | 17.3728 |
| 17 | -0.0660 | -0.3742 | 48.1013 | 17.3067 |
| 18 | 0.0220 | 0.1470 | 49.3671 | 17.3287 |
| 19 | 0.3966 | 2.0764** | 49.3671 | 17.7253 |
| 20 | -0.0330 | -0.2392 | 46.8354 | 17.6923 |

Notes: ***, **, and * indicate significant at 1%, 5% and 10% significance levels respectively.

Table 2: Explaining abnormal returns

| Explanatory Variables | Estimates Coefficients (White Standard Errors) |
|--|---|
| Constant | 0.0727 (0.0598) |
| DEBT2TA | -0.1354** (0.0668) |
| DIVPAYOUT | -0.0006*** (0.0002) |
| GROWTH | -0.0155* (0.0083) |
| INSIDER | -0.0012** (0.0004) |
| MB | -0.0827** (0.0320) |
| OUTCOME | 0.0650** (0.0314) |
| ROA | -0.6546** (0.2507) |
| TOBINQ | 0.1797*** (0.0673) |
| D1 | 0.0097 (0.0362) |
| D2 | -0.0660 (0.0449) |
| TA | 0.0000 (0.0000) |
| R- squared | 0.4102 |
| Adjusted R-squared | 0.3133 |
| F Statistics | 4.2361*** |
| Jarque-Bera χ^2 Statistics | 61.4076*** |
| Breusch-Pagan-Godfrey Heteroscedasticity χ^2 Statistics | 67.1245*** |

Notes: ***, ** and * indicate significant at 1%, 5% and 10% significance levels respectively. The standard errors are White (1980) heteroskedasticity consistent standard errors.

DEBT2TA as a proxy of financial leverage is found to be significant at 5% level. The finding supports Kim and Lyn's (1991) and Carow and Roden's (1997) arguments that firms which do not increase their leverage to optimum level have more to gain when they go private. It is because bidders usually use external borrowing to finance part of the purchase price. The larger the firm's debt capacity before buyout, the higher is the abnormal return accrues to shareholders. Financial leverage changes associated with going private transaction convey positive information and expectation of insiders about firm's future growth potential, therefore, share price are expected to increase around the period of going private announcement.

Furthermore, dividend payout is negatively correlated with abnormal gains and is statistically significant at 1% level. Shareholders would accept low dividend payout and high reinvestment rate for healthy growth company as they know that they will get higher dividend payment when the company's investment payoff. In contrast, companies with poor investment opportunities would not be allowed to invest unprofitably. Managers incentivized to retain corporate earnings by not disgorging to shareholders make going private a viable option. Under reasonable circumstances, low growth company with limited profitable investment should pay dividend to shareholders. However, separation of control and ownership sometime makes managers to place their self interest and personal goal ahead of organizational goal. Such policy would produce unsatisfactory performance and require corporate restructuring. Therefore, dividend payout should be low for targeted buyout firms. In addition, low dividends could signal that managers are trying to depress share prices before delisting the company. Lowenstein (1985) suggests that management could depress the company's share price preceding the buyout and offer a seeming premium. If target firms decrease dividend payout one year prior to the going private announcement, it signifies that there is information asymmetry. In this study, sample firms have low dividend payout in latest financial year before the going private announcement.

In addition, the coefficient of market-to-book value ratio is of expected sign and significant at 5% level confirming firms that went private are undervalued by market participants. Information gap between asset productivity between managers and investors motivate insider to opt for going private transaction (Shah and Thakor, 1988). Firms with low market valuation are a “bargains”. Going private is influence by shares overvaluation or undervaluation. If a company's share is overvalued relative to fundamental, it is unattractive takeover targets in the eyes of acquirers. Perceived low share prices of target make it more attractive to buyer to purchase the target now rather than what maybe in the future.

As predicted, the variable *OUTCOME* is statistically significant as explanatory variable. This finding is consistent with the hypothesis that successful proposal accrue higher abnormal returns to stockholders than unsuccessful proposal (DeAngelo et al., 1984). Furthermore, the regression results indicate significant negative coefficient at the 0.05 level on the variable ROA. Negative return on total asset suggests that delisting firms were performed poorly previously. Inefficient firms form natural target for insiders or outside bidders to restructure the firm. Our results lend support to inefficient management hypothesis (Mitchell and Lehn, 1990; Martin and Mcconnell, 1991). Value maximizing bidders prefer targets with the potential for improvement and add value. Going private is a viable option to turn a failing company around. In addition, parent group may take loss making subsidiaries private to restructure the inefficient business or initiate buyout when the subsidiaries no longer fit the strategic aim of the parent company.

We using proportion of equity market value represented by growth options as proxy for growth prospect followed Edey et al.'s (1996) study. Our results suggest firms with low growth prospect results in higher shareholder wealth. It implies that target firms with less valuable investment opportunities have more to gain when they are taken private. The result confirms agency cost theory which argues that high growth firms are better monitored by equity market, while low growth firms have less positive NPV investment and should be taken private to avoid managerial consumption of perquisites and increase control by not distributing excess cash to shareholders.

In the free cash flow hypothesis, Tobin's q ratio proxies for inefficient management, while under financial distress hypothesis, it proxies growth potential. Although Tobin's q ratio is significant at 1% level, it is not of expected sign.

Finally, the regression results show insignificant for the variables of method of payment and total asset. Our results does not support the argument that cash offer are interpreted as good news for market participants, while securities exchange is interpreted as bad news about the acquiring firm's prospect. On the other hand, firm size is not significant in explaining premium paid to shareholders.

5. Conclusion

The study investigates 79 going private announcements for the period 2001-2007. Using event study methodology, cumulative abnormal returns of 17.69% of abnormal return is earned 41 days surrounding the buyout announcements. The results confirm previous findings that going private announcements increase shareholder wealth. Furthermore, the study reveals some insight about the sources of abnormal returns generated by minority buyouts. Shareholder return has negative significant relationship with debt, dividend payout ratio, growth prospect, insider holding, market to book value ratio, and return on total asset and has positive relation with Tobin's q ratio and outcome of the buyout proposal. The finding suggests that firms with higher debt capacity prior to the transaction, lower dividend payout and fewer valuable investment opportunities provide higher announcement returns. Undervalued firms give higher stock return to shareholders. Besides, lower managerial equity increases shareholder premium as interest of managers and shareholders are realigned when the firm are taken off the stock bourse. The study provides evidence that poorly performed target have higher abnormal gains upon going private. Additionally, successful proposal accrue higher abnormal returns to stockholders than unsuccessful proposal. Tobin's q ratio is significant but is not of expected sign. On the other hand, abnormal returns are independent of firm size and method of payment employed to buyout the targets.

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