What Does it Take to be Good Parent?

Opening the Black-box of Value Creation in the Unrelated Multibusiness Firm

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ABSTRACT

This paper develops and tests new theory about the determinants of value creation in unrelated multibusiness firms from a resource-based perspective. We argue that the availability of headquarter resources, which are at the basis of headquarter services provided to the business units, is the driving force behind unrelated diversification. The availability of headquarter resources on the one hand and the need for the corresponding headquarter service on the other are key contingencies for value-creating unrelated diversification. We then examine the case of Leveraged Buyout (LBO) associations as one type of unrelated multibusiness firm and derive hypotheses from our theoretical model regarding the mechanisms through which the investing private equity firm (as the corporate center) adds value to the acquired portfolio companies (as business units). This analysis considers the moderating effect of: (a) relevant competencies of the private equity firm; and, (b) the need of the acquired units in these hypotheses. We test our predictions on a sample of 101 European LBO associations and find general support for our argument.

KEYWORDS:

Diversification, Private Equity, Management Buyout, Leveraged Buyout, Resource-Based View, Parenting Effect, Conglomerate
INTRODUCTION

Why do conglomerates still exist? For more than two decades, diversification theory has argued that related forms of diversification (multibusiness firms comprised of a number of units that share several critical resources) are superior (see e.g. Ramanujam and Varadarajan 1989). At the same time, the vast majority of empirical studies comparing the performance of unrelated multibusiness firms to either single-business firms or related diversifiers, found that the multibusiness firm underperformed (e.g. Rumelt 1982; Singh and Montgomery 1987; Montgomery and Wernerfelt 1988; Lubatkin and Chatterjee 1994; Markides and Williamson 1994; Montgomery 1994; Anand and Singh 1997). This empirical evidence would lead us to expect conglomerates to disappear over time due to market pressures. Indeed, the popularity of unrelated multibusiness firms has decreased substantially since the 1970s and the restructuring wave of the 1980s led to the break-up of a number of large conglomerates, in particular through leveraged buyout transactions.

However, this trend has slowed down in recent years and still today a significant portion of economic activity is organized in conglomerate-type unrelated multibusiness firms. Even more surprisingly, some of these firms perform extraordinarily well, both in terms of the fundamental profitability of their business units and in terms of their stockmarket performance. Take Australia’s Wesfarmers for example, which is composed of a remarkable breadth of businesses ranging from an insurance company to coal mining and production. Despite its portfolio of unrelated businesses, Wesfarmers’ stock has increased more than 400% in the last ten years. In comparison, the Australian ASX All Ordinaries stock index has risen by only 123% in the same period. Some companies apparently are able to create substantial value through the combination of a wide range of unrelated activities under one corporate roof. Similarly, some of these firms seem to add
substantial value by acquiring unrelated businesses and adding them to their portfolio of activities.

These observations lead us to question how this type of “conglomerate” value creation in unrelated multibusiness firms can be explained in the absence of any form of relatedness between the different business units. While we have a detailed understanding of the mechanisms through which related diversification can be a source of economic rents (e.g. Rumelt 1974; Singh and Montgomery 1987; Markides and Williamson 1994; Tanriverdi and Venkatraman 2005), the exact processes and necessary corresponding skills and resources through which unrelated multibusiness firms are able to create shareholder value remain poorly grasped.

This paper is an effort to shed fresh light on the question why unrelated multibusiness firms exist and how some are able to prosper and create substantial value. The starting point of our discussion is a review of the theoretical foundations of the multibusiness firm and relevant arguments from diversification theory. This allows us to elaborate on Goold and Campbell's initial insight that some sort of "parenting advantage" (Goold 1991) is at the origin of any form value creation in unrelated multibusiness firms. By discussing the nature of the value-creating processes between headquarters and business units, we are able to identify specific conditions under which we expect value creation to occur based on a parenting effect. Essential in this context are: (a) the availability of headquarter resources; and, (b) the need of the business unit for these resources. These two conditions are key contingencies for value creation through unrelated diversification.

The paper then progresses by examining a specific empirical setting in which it is possible to observe the parenting advantage and to isolate the performance impact of some of the corresponding resources and processes. As highlighted by Baker and Montgomery (Baker and Montgomery 1994), leveraged buyouts can be seen as a specific type of unrelated acquisition (see Figure 1). In fact, conglomerates and Leveraged Buyout (LBO) associations share a number of

1 Alternative explanations for this finding also exist, however. See, for example, Villalonga (2000).
important characteristics, including the unrelated and stand-alone nature of their business units, and headquarters’ focus on a limited number of value-creating activities (see Table 1 drawn from Baker and Montgomery 1994). In this sense, the way in which Leveraged Buyout associations (Jensen 1989) create value for their funds’ investors by acquiring unrelated businesses and managing them as stand-alone entities for a number of years, can be seen as a pure form of the value creation at work in traditional unrelated multibusiness firms. Specific to this setting, we develop a number of hypotheses regarding: (a) the exact processes through which private equity (PE) firms create value independent of operational synergies; (b) the crucial resources that enable them to do so; and, (c) the characteristics of business units in which PE firms with the corresponding headquarter resources can add value through these processes. We then test these hypotheses on a sample of 101 European LBO associations. Our findings suggest that the corporate center in unrelated multibusiness firms, such as Leveraged Buyout associations, can indeed add value and they provide support for the hypothesized contingencies for the parenting effect.

--- Insert Table 1 about here -----

The remainder of the paper is structured as follows. The first section builds on the relevant literature on existing theories of multibusiness firms and outlines a theory of unrelated diversification. Section two applies these arguments to LBO associations and develops testable hypotheses regarding processes and contingencies of value creation in this context. Section three introduces the empirical setting for this study and discusses the research design and methodology. Section four presents the results of the empirical analysis, and the final section discusses their implications and outlines an agenda for further research.
TOWARDS A THEORY OF THE UNRELATED MULTIBUSINESS FIRM

The majority of economic activity today is organized in multibusiness firms, so-called to the extent that they operate in at least two major business areas (Rumelt 1974). Provided that the cost of organizing increases with the scope of activities (due to increased complexity), the joint performance of multiple activities under a common corporate roof has to be justified by some form of advantage arising from it (Teece 1982).

Penrose’s (Penrose 1959) theory of the growth of the firm provides the fundamental argument to explain the development of multibusiness firms. Firms are bundles of resources, some of which may not be fully utilized by the current scale of activities. In those cases, these "slack resources" can be profitably applied to other activities. Hence, firms may be able to create additional rents from available resources by expanding the scope of their activities. This option is particularly attractive when firms cannot simply capture rents from their slack resources by selling them in the strategic factor market, i.e. in the case of resources that are subject to market failure (Teece 1982).

Based on this original insight, a number of researchers have attempted to specify the types of activity that could expand a firm’s scope in a rent-generating fashion. The theoretical and empirical focus of this diversification literature has typically been the relatedness between existing and new activities. Some level of relatedness between the two has been identified as necessary for available resources to be rent generating (e.g. Rumelt 1974; Ramanujam and Varadarajan 1989), but the nature of relatedness may vary (Stimpert and Duhaime 1997; Farjoun 1998).

Overall, a number of arguments for the superiority of related multibusiness firms exist, and these are complemented by broad empirical support for the claim that unrelated diversifiers underperform their related diversified or single-business peers (e.g. Montgomery 1994; Rumelt
This is consistent with the fact that the number of multibusiness companies that follow a strategy of unrelated diversification has decreased substantially since the 1970s (Goold and Luchs 1993). In fact, the break-up of large conglomerates into smaller and more focused entities, often through leveraged buyouts, was an important component of the restructuring wave in the US in the 1980s (Baker and Montgomery 1994).

Nevertheless, there is clear evidence that some conglomerates demonstrate extraordinary performance. France’s Fimalac provides another example. It engages in an array of unrelated businesses ranging from financial services to furniture. The stock price of Fimalac has risen by more than 270% in the last ten years, whereas the French SBF 120 has increased by 121%. While this does not contradict the empirical finding that related diversifiers or single business firms have a performance advantage on average, it still raises the question how these successful conglomerates are able to create value for their shareholders through the management of a number of unrelated businesses within one organization. Of course, it would be easy to respond to this evidence by stating that such high-performing conglomerates are simply the result of luck or are the famous exception to the rule. We argue, however, that there is more to these firms’ success and that it may indeed be possible to develop a theory regarding why and how some conglomerates succeed. In other words, what we need is a theory that explains the existence and performance of unrelated multibusiness firms through a specific form of value creation. The nature of this form of value creation is indeed quite different from the type of value creation that is driving performance in related diversification. The implications of this difference will become clearer when we take a closer look at the different types of synergies that underlie various kinds of multibusiness firms.
A Closer Look at Synergies

The term “synergies” has been used as a label for the range of (cost- or revenue-based) advantages that stem from the joint performance of multiple activities, such as economies of scale, economies of scope, joint-learning etc. (Ramanujam and Varadarajan 1989), including the purely financial advantage of combining imperfectly correlated cash flows. It is helpful for our subsequent argument to conceptually distinguish between different types of synergies depending on the distinct processes that underlie them.

On the one extreme we have the ‘financial synergies’ that result from the combination of imperfectly correlated cash flows of different businesses within the same company. This type of synergy does not require any interaction or integration of the combined businesses and can be achieved through a financial holding or even through mutual funds. At the other extreme, there are ‘operational synergies’ based on the broad range of advantages through the joint execution of related operations (Ramanujam and Varadarajan 1989; Palepu 1985; Farjoun 1998). Capturing these advantages commonly requires, in addition to some type of relatedness between the different businesses, also intense interaction between the different business units of a multibusiness firm. Often, the organizational integration of the different business is stated as a further requirement for these operational synergies to occur (Ramanujam and Varadarajan 1989). It is important to note that the nature of relatedness, integration and interaction can vary substantially depending on the specific context (Stimpert and Duhaime 1997). The key point is, however, that these synergies are based on lateral processes that occur between the different business units of a multibusiness firm.

Unrelated multibusiness firms do not generally meet either of these requirements: the activities of the different business units are unrelated by definition and the level of interaction and integration between the business units of an unrelated multibusiness firm is substantially lower than
for its related peers. Thus ‘operational synergies’ cannot be at the origin of value creation in this context. The dominant type of interaction in unrelated multibusiness firms takes place between the corporate headquarters and the individual business units (Goold, Campbell et al. 1994). It is through such interaction between corporate headquarter and the business unit that unrelated multibusiness firms are able to create synergistic advantages beyond the pure financial synergies that could also be captured through a much more simple organizational arrangement. The exact mechanisms through which this interaction can be a source of value creation will be discussed in more detail in the following paragraph.

**Existing Theories and Approaches to Explain Unrelated Value Creation**

While most research efforts have concentrated on explaining value creation in multibusiness firms based on the relatedness of activities and organizational integration and/or interaction among business units, the general outline of a theory to explain the existence and performance of unrelated multibusiness firms has already been articulated. Goold and Campbell (Campbell, Goold et al. 1995; Goold and Campbell 1998) have argued that the organization of business activities in unrelated multibusiness firms can be economically efficient whenever the corporate center is able to provide some form of "parenting advantage" to its subsidiaries that outweighs the costs incurred due to the additional organizational complexity of having multiple activities in the same firm (Goold 1991). It is important to note that this parenting advantage relies neither on a relatedness of business-unit level activities nor on any lateral integration or interaction between different business units. It is instead, the result of a specific form of influence of the corporate parent on the business unit. This effect has been termed “standalone influence” by Goold and Campbell. At the minimum, this influence entails being “involved in agreeing and monitoring performance targets, in approving
major capital expenditures, and in selecting and replacing the business unit chief executives” (Campbell, Goold et al. 1995, p. 81). Going further, it entails getting involved in “a wider range of issues, such as product-market strategies, pricing decisions, and human-resource development” (Campbell, Goold et al. 1995, p. 81). Operational synergies and parenting advantage are in fact not necessarily mutually exclusive. In some cases, the corporate parent of a related diversifier can also add value to its business units. The point, though, is that relatedness is not a necessary condition for this type of value creation.

While this theory constitutes a useful starting point for our argument, it has some limitations. In particular, the boundary conditions under which the stand-alone influence of the corporate parent creates value remain somewhat unclear in Goold and Campbell’s theory:

“While corporate parents can create value through stand-alone influence, they often destroy value instead. By pressing for inappropriate targets, by starving businesses of resources for worthwhile projects, by encouraging wasteful investment, and by appointing the wrong managers, the parent can have a serious adverse effect on its businesses. The potential for value creation must therefore always be balanced against the risk of value destruction.” (Campbell, Goold et al. 1995, p. 81)

The argument remains fairly abstract, in the sense that only a list of activities is provided through which a parenting advantage can potentially be created. It remains unclear to what extent this list is exhaustive, and more importantly, under what conditions we can expect an activity to be a source of a parenting advantage for a conglomerate with a corporate center and business units of given characteristics. At the same time, it is difficult to derive testable hypotheses from the generic argument that conglomerate performance is explained by parenting activities through which the corporate center may or may not be creating value. In particular, it seems to be difficult to falsify Goold and Campbell’s theory. In fact, one could say that whenever we observe a high-performing conglomerate, there must be some form of parenting advantage at work. Conversely, whenever a
conglomerate underperforms, it must be because it does not provide a sufficient parenting advantage. Consequently, we need to add to the notion of the "parenting advantage", especially with respect to contingencies and boundary conditions, in order to explain the existence and performance of unrelated multibusiness firms. Also, it will be important to define more clearly which theoretical mechanism ultimately drives the parenting advantage in conglomerates, \textit{i.e.} what type of resources are responsible for a value-enhancing parenting effect and in what direction they drive unrelated diversification.

\textbf{Driving Force and Direction of Unrelated Expansion}

We need to gain further insight into the mechanisms through which unrelated multibusiness firms add value to their business units. To this end, it is helpful to return to the theoretical origins of multibusiness firms in general. As mentioned above, Penrose (Penrose 1959) first argued that firms’ ability to generate rents by applying available resources to additional activities drives expansion. The question is then: what \textit{type} of additional activity enables a firm to generate the maximum amount of rents from these resources? As we have seen, the diversification literature provides some clear answers. Available resources from existing activities can be most profitably applied to new activities that are \textit{related} to existing ones in one way or the other (Penrose 1959; Rumelt 1974). Indeed, cross-business relatedness has been measured in remarkable breadth: e.g. product, manufacturing, technological, R&D, marketing, advertising and human resource relatedness (Tanriverdi and Venkatraman 2005).

The argument for relatedness makes intuitive sense for those resources that are closely linked to the activities of individual business units. Beyond resources located in individual business units however, multibusiness firms also possess resources in their corporate center that are used to
provide some form of headquarter service to the business units. According to Penrosean reasoning, firms will accumulate this special type of managerial resource (referred to hereafter as headquarter resources) over time so that at some point, unused headquarter resources will be available to the firm. Based on the resource-based view of the firm (e.g. Barney 1991; Dierickx and Cool 1989; Peteraf 1993; Wernerfelt 1984), these resources need to be valuable, rare, inimitable and non-substitutable in order to constitute a potential source of economic rents.

How then does a firm capture rents from these resources? In some cases, the feasible option will be to capitalize on headquarter resources by simply selling them on the strategic factor market. One example is Porsche Consulting, the consulting unit of the German car manufacturer that offers specialized headquarter services, not only within Porsche, but also to help external clients enhance the efficiency of their manufacturing processes.

In many cases, however, headquarter resources (which are often knowledge resources) are subject to market failure. Just as with business unit resources, the best way for a firm to capture rents from headquarter resources is then by applying them to additional activities or business units (Teece 1982). The availability of headquarter resources thus may push the firm towards expanding its scope of activities. In the case of headquarter resources, however, relatedness may be a much less important determinant of the optimal expansion activity than is the case for related resources at the business-unit level.

Instead, we propose an alternative logic that determines the direction of unrelated diversification. In fact, the most profitable use of headquarter resources may be in a business unit that needs that type of headquarter service, rather than a business unit that performs related activities. More precisely, whereas the most profitable use of a business unit resource will be in a business unit performing related activities (based on operational synergies), the most profitable use
of a headquarter resource will be in a business unit that lacks this particular type of headquarter resource (based on the parenting advantage).

A good example of creating value based on a unique ability to provide headquarter-type services is provided by Bill Bain and his team. They possessed the “headquarter resource” of coaching, turnaround management and operational improvement and first began capturing rents from this by selling management consulting services through Bain & Company. Founded in 1973, Bain & Company’s motto was “we sell you your profits at a discount”. Maybe it were the limitations of capturing all the rents from this resource that pushed Bill Bain and his core team to move away from consulting and to found the PE firm Bain Capital in 1984. As a result, they were able to “buy profits at a bargain” as their new motto put it, *i.e.* by purchasing businesses in need of coaching, turnaround management or improved operational efficiency. By providing these services, then selling the companies at a substantial profit, Bain Capital was able to capture a larger part of the rents generated by its “headquarter resource”.

In summary, our theoretical model explains value creation through unrelated diversification as follows (see Figure 2). Unrelated diversification is value-creating if, and only if, it takes place between an acquiring corporate center and an acquired business unit with the following characteristics: (a) the acquired business unit needs a particular headquarter service, such as improved working capital management or efficient budgeting; and, (b) the acquiring corporate center possesses (sufficient) headquarter resources that can provide precisely these headquarter services, and (c) that these services cannot be effectively traded on the strategic factor market. Hence the requirements of the business unit and the availability of headquarter resources determine the possibility and direction of value-creating unrelated diversification.
Value Creation through the Application of Headquarter Resources in LBO Associations

Leveraged Buyout (LBO) associations (Jensen 1989) constitute an example of unrelated multibusiness firms. They share important features with traditional conglomerates (see Table 1 based on Baker and Montgomery 1994), such as the unrelated nature of their different activities and the standalone character of their business units, which are typically called buyout "portfolio companies". In contrast to traditional conglomerates (which are publicly traded), LBO associations usually raise money through a limited liability partnership and are thus required to exit their investments after an average of four to eight years. The limited life of buyout investments makes LBO associations an interesting setting for analyzing the value creation mechanisms in unrelated multibusiness firms, as the entry and exit of a Leveraged Buyout provide accurate evaluations of the acquired unit based on which value creation or destruction can accurately be measured. Publicly traded conglomerates and LBO associations also differ in terms of their headquarters structure and the incentives they offer to operating units. Publicly traded conglomerates are typically hierarchical with a CEO presiding over group vice presidents and headquarter staff, whereas LBO associations are without a formal structure with all associates reporting to a small group of investment managers at the responsible private equity firm. Also, whereas publicly traded conglomerates are limited to performance-based bonuses as management incentives, LBO associations usually offer some form of equity ownership to portfolio company managers. Although headquarter structure and operating unit incentives may have a moderating impact on the value created by headquarter resources, the existence of an actual need for these services and their availability will be equally important value drivers for conglomerates as for LBO associations.
Prior research on value generation in buyouts has pointed to the importance of value generation processes that take place between the investing private equity firm and the acquired portfolio company (e.g. Berg and Gottschalg 2005). Buyout value generation is then not only a question of the characteristics of the acquired units and external market or industry trends; it is also inherently linked to the specific characteristics of the acquiring private equity firm. In other words, it also depends on the availability of valuable headquarter resources that can be applied to the acquired portfolio company in a performance-enhancing and value-creating fashion. This process is thus consistent with the previously outlined mechanism of value creation in unrelated multibusiness firms in general.

This study aims to test the previously developed theoretical model of value creation in unrelated multibusiness firms in the LBO setting. To derive specific hypotheses regarding the nature of parenting activities and their boundary conditions from the general theory, it is first necessary to develop a more precise understanding of the exact mechanisms through which the private equity firm that serves as the corporate center, or headquarters, of the Leveraged Buyout association is able to contribute to value generation in its portfolio companies. To increase the comparability with other unrelated multibusiness firms, the focus will be on processes and activities during the holding period of the buyout, rather than activities related to the acquisition and divestment of the portfolio company. While we agree that buyout value generation takes place during all three phases (acquisition, holding and divestment) of the buyout process and that the investing private equity firm has an influence during these phases (Berg and Gottschalg 2005), we consider the processes at work during the holding period to be most similar to the forms of value creation that can be observed, for example, in unrelated conglomerates.

In the following, we identify four specific activities through which private equity firms can
influence buyout value generation. These are the result of both an in-depth review of the existing literature on how the private equity firm’s interactions with portfolio companies affects buyout value generation, and of extensive fieldwork in the private equity domain. We conducted a total of 25 semi-structured interviews with industry experts, such as senior private equity firm investment managers, members of the portfolio company top management team and consultants to LBO associations.

One way in which private equity firms can add value to their portfolio company is by offering financial assistance and support. Value generation in buyouts partly stems from the improvement of the financial structure (e.g. Campbell, Goold et al. 1995; Cotter and Peck 2001) or the reduction of capital requirements (e.g. Singh 1990; Smith 1990; and Seth and Easterwood 1993). During our interviews, it was mentioned frequently that consultations between portfolio company management and private equity firm investment managers play an important role. Often, the financial expertise of private equity professionals is a crucial enabler for buyout portfolio companies to better manage their assets and liabilities. Consequently, we expect the private equity firm’s involvement in the financial management of its portfolio company to contribute to buyout value generation. This can be formally stated in the following hypothesis:

\[ H1a: \text{An involvement of a private equity firm in the financial management of its portfolio company leads to greater performance of the buyout.} \]

A second aspect through which private equity firms can add value in buyouts is their involvement in decisions regarding the composition of the portfolio company’s top management team. Prior research has argued that buyouts provide good examples of the strength of the market for corporate control (Manne 1965) and that the reduction of managerial inefficiencies through
replacements in the top management team (Jensen and Ruback 1983) are a fundamental buyout value generation mechanism (Anders 1992). The investing private equity firm, which often holds a controlling equity stake in the acquired company, plays a key role in the selection of new members of the top management team. In many cases, their network of seasoned managers from many industries (Bruining and Wright 2002; Baker and Smith 1998) helps identify and recruit the human resources essential to making the buyout work. Thus, we expect that a private equity firm’s involvement in the recruitment of top managers for its portfolio company will contribute to buyout value generation. This leads us to hypothesize that:

**H1b: An involvement of a private equity firm in the recruitment of top managers for its portfolio company leads to greater performance of the buyout.**

Another key area in which private equity firms can help their portfolio companies become more profitable is through coaching and counseling in setting the strategic direction, in defining performance targets and in developing detailed business plans (Anders 1992; Baker and Montgomery 1994; Baker and Wruck 1989). The enhancement of strategic distinctiveness and the development of ambitious "stretch budgets" are important ingredients of successful buyouts (e.g. Berg and Gottschalg 2005). Buyout portfolio companies can benefit from the expertise of professionals from the private equity firm if investment managers are involved in strategic decisions and in developing corresponding performance targets and execution plans. Hence, we expect the private equity firm’s involvement in the strategic decision making of its portfolio company to contribute to buyout value generation. In other words:

**H1c: An involvement of a private equity firm in the strategic decision making of its portfolio company leads to greater performance of the buyout.**
Operational improvements in the acquired companies were mentioned as sources of buyout value generation in the earliest academic studies of buyouts (Bull 1989; Anders 1992; Hite and Vetsuypens 1989). The focus of many private equity firms has since extended beyond participating in financial, strategic and human resource-related decisions and to active involvement in initiating operational improvements during the buyout. The industry pioneers Clayton, Dubilier & Rice have led this trend (Kester and Luehrman 1995). According to a recent survey, 60% of UK private equity firms are regularly involved in operational decisions to improve the performance of their portfolio companies (CMBOR and INSEAD 2004). Therefore, we can expect that a private equity firm’s involvement in the operational decisions of its portfolio company will contribute to buyout value generation. More formally:

**H1d: An involvement of a private equity firm in the operational decisions of its portfolio company leads to greater performance of the buyout.**

Thus far, our hypotheses focused on activities through which PE firms can add value during the buyout. It is important, however, to keep in mind the important contingencies for a value-creating parenting effect identified in the preceding theoretical discussion. We first consider the availability of headquarter resources to provide value-creating headquarter services. Only private equity firms that possess the relevant headquarter resources, *i.e.* a specific capability to improve the quality of decision making and implementation in the above discussed four areas, can be expected to add value. It can be expected that this capability is largely tacit and context specific, so that it is only imperfectly tradable on the strategic factor market (Barney 1986). Private equity firms as a result, cannot fully capture the rents from those resources by simply selling them (e.g. as consulting
services) to other companies. Instead, private equity firms will find it optimal to capitalize on their capabilities through a value-enhancing involvement in the management of portfolio companies. At the same time, the tacit and context-specific nature of this capability leads us to expect that experiential learning (Zollo and Winter 2002) is likely to be the driving force behind the development of these capabilities. If we take prior experience as a proxy for the possession of the specific capability to be successfully involved in the financial, recruitment, strategic and operational decisions of the portfolio company, we would expect that the hypothesized relationships H1a, H1b, H1c and H1d will be moderated by the prior experience of the private equity firm in the following fashion:

**H2a:** The greater the prior experience of the private equity firm, the more positive the performance impact of an involvement of a private equity firm in the financial management of its portfolio company.

**H2b:** The greater the prior experience of the private equity firm, the more positive the performance impact of an involvement of a private equity firm in the recruitment of top managers for its portfolio company.

**H2c:** The greater the prior experience of the private equity firm, the more positive the performance impact of an involvement of a private equity firm in the strategic decision making of its portfolio company.

**H2d:** The greater the prior experience of the private equity firm, the more positive the performance impact of an involvement of a private equity firm in the operational decisions of its portfolio company.

Finally, we need to consider the second important contingency identified in our previous discussion. The ability of an unrelated multibusiness firm to capture rents from the application of headquarter resources fundamentally depends on whether they can be profitably applied to new
activities. Or, in the case of the Leveraged Buyout association, it depends on the *need* of the portfolio company for the particular type of support and expertise that can be provided by the PE firm. Of course, “need” for a specific service is difficult to observe in detail. At the most aggregate level, we can consider the financial performance of the portfolio company prior to the buyout as a proxy for the degree to which this company needs, or can benefit from, the expertise of the acquiring private equity firm. In other words, we can expect portfolio companies that show high levels of performance relative to their industry peers to offer little value generation potential based on the application of the expertise of the acquiring private equity firm. On the other hand, the value of portfolio companies that underperform their competitors can be substantially increased through an application of the private equity firm’s capabilities via its involvement in any of our four critical value-creating activities. Consequently, we predict that:

**H3:** The relationships hypothesized in H1a, H1b, H1c and H1d will be stronger for portfolio companies that underperform their industry peers prior to the buyout than for buyouts of companies that outperform their competitors.

A summary of the theoretical model and the hypothesized relationships developed by this study is shown in Figure 3.

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**METHODS**

**Sample**

Our hypotheses were tested on 101 European LBO associations, looking at the dyadic relationship between the PE firm (as the corporate center) and one of its portfolio companies. Leveraged
management buyouts provide an ideal setting for testing our hypotheses for the following three reasons. First, the specific processes adopted and resources employed when parenting a portfolio company can be readily observed. Private equity firms have a narrow personnel base and are usually without functional divisions and rigorous hierarchies. Any private equity professional will therefore be well informed with regard to the parenting processes and resources applied to a specific leveraged management buyout. Second, the value created in a buyout can be assessed with a (relatively) high degree of accuracy and objectivity. Buyouts are typically based on a detailed business plan developed at the time of the investment, and these can be used to measure subsequent performance. Even more importantly, most buyouts involving private equity firms have a limited investment horizon (Baker and Montgomery 1994), so that the change in performance relative to competitors as well as the equity investor’s realized return on equity (annualized Internal Rate of Return (IRR)) can be observed as objective performance measures after the exit. In addition, to the extent that the market for corporate control is efficient, the PE firm pays a price for the acquired unit that reflects its value to the next best acquirer. In theory, then, one can interpret the value creation we observe during the buyout as the difference between the parenting ability of the PE firm and the parenting ability of the next best potential owner. Third, buyouts are usually stand-alone acquisitions that tend to leave the resource configuration of the acquired company relatively unchanged (Berg and Gottschalg 2005); therefore, the parenting effect can be observed in isolation, as no operational synergies occur in this setting.

Our sample is composed of 101 LBO associations. The PE firms at the head of these agreed to participate and filled in a questionnaire for one randomly selected portfolio company. Private equity firms were identified based on the information provided by private equity and venture capital industry associations, industry directories as well as Internet searches. This led to the initial
identification of 500 private equity firms possibly engaged in buyout financing in Europe. Out of that total, 46 private equity firms had to be dropped, as they were either a fund of funds, had not yet completed a buyout investment, or no longer existed. This left us with a total of 454 private equity firms to which the survey was sent in October 2003. After three weeks, a reminder was sent to all private equity firms that had not responded in the first round. Overall, 101 private equity firms agreed to participate in our survey, corresponding to a response rate of 22%.

The questionnaire was sent to the most knowledgeable respondent, who was identified through the various databases employed. Most of the respondents were partners or managing partners (67%) of the respective private equity firms, while 22% of the respondents held investment manager positions. In the case of 11% of the respondents, the position held is unknown. Given that private equity firms are usually without functional divisions and rigorous hierarchies, different professionals of one private equity firm will filter information similarly, rendering a material key informant bias (Bagozzi, Yi et al. 1991; Kumar, Stern et al. 1993) unlikely.

The degree to which this sample is representative of the entire universe of leveraged management buyouts in Europe is difficult to assess, as the key characteristics of buyouts are confidential and even basic information on the overall population is unavailable. The response rate of 22% indicates, however, that this study is representative with regard to participating European buyout firms. Another indication of its representativeness was obtained by examining the response rate by country. This gave us a relatively homogeneous picture (see Figure 4). We further tested for a possible non-response bias by dividing the sample into a group of early respondents and a group of late respondents. On the basis of the two samples obtained, two sided t-tests were conducted for all items, testing whether the mean responses of both groups were significantly different. The absence of significant differences between early and late respondents makes us confident that the
analysis will not be affected by a substantial non-response bias (Armstrong and Overton 1977). The risk of a self-selection bias in our sample has been minimized by asking participating buyout firms to randomly choose one of their portfolio company (the first in the alphabet). Consequently we consider our data to constitute a sufficiently representative sample of European leveraged management buyouts.

The questionnaire used was based to a large extent on existing scales. However, most of the constructs used in prior studies were not adapted to the buyout context. Thus, scales derived from prior studies, as well as newly developed scales, were fine-tuned in the course of 17 detailed interviews with senior private equity executives involved in European buyouts. Based on these interviews, individual questionnaire items, as well as the questionnaire as a whole, were refined to ensure measurability and clarity. The measurement of the variables used is elaborated in the following.

**Dependent Variable**

We measured value creation in leveraged management buyouts (PERFORMANCE) using two subjective measures (Schefczyk and Gerpott 2000). First, study participants were asked for the performance of their portfolio company relative to business plan (PERFBIZP) on an eight-point Likert scale (0 = “total loss”; 1 = “worse”; 4 = “same”; 7 = “better”). Second, study participants were asked for the performance of their portfolio company relative to competitors: (a) at acquisition (0 = “in bankruptcy”; 1 = “worse”; 4 = “same”; 7 = “better”); and, (b) currently/at exit (0 = “total loss”; 1 = “worse”; 4 = “same”; 7 = “better”). We used the difference between the subjective performance relative to competitors at exit and at acquisition (VALUEADD) as a measure of value.
creation. While one cannot exclude the possibility of reporting biases in subjective measures of value creation, prior research has shown that subjective measures have the advantage of being correlated to a large number of objective measures (Dess and Davis 1984; Brush and Vanderwerf 1992) and show a high disclosure rate, especially when compared to objective measures (Chandler and Hanks 1993). This is particularly relevant in the PE industry with its legendary reluctance to report objective performance measures. Despite this fact, we were able to obtain an objective measure of value creation (the annualized return on equity of the deal (IRR)) for 47 of the total 101 leveraged management buyouts. Based on this, we were able to validate the subjective measures of value creation. IRR shows a positive and significant correlation with PERFBIZP at 0.42 (p<0.01), whereas the correlation of IRR with VALUEADD is insignificant at 0.08. The results of this analysis have to be treated with caution, however, since study participants reported the IRRs of successful buyouts only – sticking with subjective measures of buyout value creation for less successful ones. Given furthermore, that there is a positive and highly significant correlation between PERFBIZP and VALUEADD at 0.43 (p<0.001), we decided to keep VALUEADD as a subjective measure of value creation. The two subjective measures of buyout value creation were treated as items of an overall value creation factor (PERFORMANCE) extracted with the help of principal components analysis (α=0.60). PERFORMANCE is positively and significantly related to IRR at 0.34 (p<0.05).

Independent Variables

The parenting activities operations, finance, management recruiting and strategy were measured as follows. Respondents used a seven-point Likert scale (1 = “low involvement” to 7 = “high involvement”) to indicate their level of involvement in each of the following areas.
**Operations**

Private equity professionals rated the extent to which they engaged in the activities “focusing or consolidating operations” (“OPS1”), “soliciting suppliers” (“OPS2”) and “optimizing working capital” (“OPS3”). We treated the three measures of involvement in operations as items of an overall Operations factor extracted with the help of principal components analysis ($\alpha=0.72$).

**Finance**

Private equity professionals completed two items of MacMillan et al.’s (MacMillan 1989) measure: “obtaining alternative sources of debt or equity financing” (“FINANCE1”) complemented by the item “selling non-required assets” (“FINANCE2”) to get a good picture of private equity firms’ activities in the field of finance. One overall finance factor was extracted from the above items with the help of principal components analysis ($\alpha=0.70$).

**Management Recruiting**

Private equity professionals completed three items of MacMillan et al.’s (MacMillan 1989) measure: “searching for candidates of management team” (“MRECRUT1”), “interviewing and selecting management team” (“MRECRUT2”) and “negotiating employment terms with candidates” (“MRECRUT3”). The three items were extracted as one overall management recruiting factor based on principal component analysis ($\alpha=0.86$).

**Strategy**

Private equity professionals rated the extent to which they engaged in the activities “directing
business plan” (“BD1”) and “defining acquisition and divestment program” (“BD2”). With the help of principal component analysis, one overall strategy factor was extracted (α=0.61).

**Prior Experience**

We measured the prior experience of a private equity firm as a proxy for the available parenting capability. Past research in judgment and decision making has shown different effects of increased experience on decision quality. On the one hand, there is evidence that more experienced individuals tend to develop more efficient decision processes (Chase and Simon 1973; Choo and Trotman 1991; Weber 1980). For example, increased experience helps an individual to focus on the key dimensions of a problem and to ignore extraneous variables. On the other hand, increasing experience may not always result in better decisions. For example, increasing experience may induce an individual to suffer from overconfidence, overestimating the likelihood of certain events (Oskamp 1982; Mahajan 1999). It remains unclear therefore whether or not more experience will result in better decision making. As a proxy for the experience possessed by each acquiring private equity firm, study participants reported the experience of the partner or director mainly responsible for the portfolio company in question along the dimensions “work experience in professional services” (“PROVSERV”), “private equity experience” (“PRVTEQTY”), “P&L responsibility” (“PLRESPON”) and “work experience in the portfolio company’s industry” (“PORTINDU”). Respondents used a fully anchored seven-point Likert scale (1 = “0-6 months”; 2 = “6-12 months”; 3 = “1-2 years”; 4 = “2-4 years”; 5 = “4-8 years”; 6 = “8-16 years”; 7 = “>16 years”) for reporting. Given that the experience in each of the dimensions was assumed to contribute to the overall experience of a private equity partner, we used the z-score of the sum of all experience measures to form the overall experience measure.
Control Variables

In line with findings from prior research on buyout value generation (Berg and Gottschalg 2005), we included a number of control variables in our statistical model. We controlled for idiosyncratic effects of specific years of entry on value creation in a leveraged management buyout by using entry-year dummies as control variables as well as for the impact of the industry of a leveraged management buyout by using industry dummies as control variables.

Overall Model

The nested models used to test our arguments are specified as follows:

Direct Effect of Interventions

\[
\text{PERFORMANCE} = \alpha_0 + \beta_1 \text{Finance} + \beta_2 \text{Management recruiting} + \beta_3 \text{Strategy} + \beta_4 \text{Operations} + \text{Controls} + \varepsilon.
\]

Individual Interaction Effects of Experience

\[
\text{PERFORMANCE} = \alpha_0 + \beta_1 \text{Finance} + \beta_2 \text{Management recruiting} + \beta_3 \text{Strategy} + \beta_4 \text{Operations} + \beta_5 \text{Experience} \times \text{Finance} + \text{Controls} + \varepsilon.
\]

\[
\text{PERFORMANCE} = \alpha_0 + \beta_1 \text{Finance} + \beta_2 \text{Management recruiting} + \beta_3 \text{Strategy} + \beta_4 \text{Operations} + \beta_5 \text{Experience} \times \text{Management recruiting} + \text{Controls} + \varepsilon.
\]

\[
\text{PERFORMANCE} = \alpha_0 + \beta_1 \text{Finance} + \beta_2 \text{Management recruiting} + \beta_3 \text{Strategy} + \beta_4 \text{Operations} + \beta_5 \text{Experience} \times \text{Strategy} + \text{Controls} + \varepsilon.
\]

\[
\text{PERFORMANCE} = \alpha_0 + \beta_1 \text{Finance} + \beta_2 \text{Management recruiting} + \beta_3 \text{Strategy} + \beta_4 \text{Operations} + \beta_5 \text{Experience} \times \text{Operations} + \text{Controls} + \varepsilon.
\]

Full Model with Joint Interaction Effects of Experience

\[
\text{PERFORMANCE} = \alpha_0 + \beta_1 \text{Finance} + \beta_2 \text{Management recruiting} + \beta_3 \text{Strategy} + \beta_4 \text{Operations}
\]
\[ + \beta_3 \text{Experience x Finance} + \beta_6 \text{Experience x Management recruiting} + \beta_7 \text{Experience x Strategy} + \beta_8 \text{Experience x Operations} + \text{Controls} + \varepsilon \]

The nested models are first applied on the full sample of portfolio companies and then to: (a) a subsample of portfolio companies that underperform their industry peers prior to the buyout; and, (b) a subsample of portfolio companies that outperform their competitors.

**RESULTS**

Descriptive statistics of all items used in this study are reported in Table 2a, descriptive statistics of the original survey items for the subsample of portfolio companies that under- and outperform their industry peers prior to the buyout are shown in Tables 2b and 2c. The bivariate correlation matrix for the theoretical scales is reported in Table 3. The dependent variable (Performance) correlates strongly and positively with the operational involvement factor (p<.01). Strongly significant bivariate correlations among a number of our scales suggest that a multivariate analysis of their impact on performance would be necessary.

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Insert Tables 2 a,b,c about here
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Table 4 reports multivariate regression results for the full sample. Starting with base Model 1 that includes only control variables and the main effects, we add the interaction effects one at a time and finally analyze the impact of adding all interaction effects simultaneously.

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Insert Table 3 and 4 about here
---

With regard to base Model 1, which measures the direct effect of an involvement of the PE firm in the different areas, independent of experience and prior performance of the acquired unit,
only the main effect for an involvement in operational decisions is positive and significant (p<.01).
This finding which is consistent through all different specifications of our model for the full sample,
suggests (in support of H1d) that private equity firms’ involvement in the operations of a leveraged
management buyout is generally beneficial. All the other main effects are not significant in this
analysis. Hypotheses H1a, H1b and H1c are therefore not supported.

Model 2 adds the interaction of experience and involvement in the target company’s
financial management. The addition of this interaction term increases the variance explained
significantly (adj. R² change = 0.03, p<.1). In support of H2a the coefficient of the interaction term
is positive and significant (p<.1). The relationship between the involvement in the target company’s
financing and value creation is therefore more positive when experienced private equity
professionals are involved.

Model 3 adds the interaction of experience and an involvement in management recruiting.
The interaction here is not significant, indicating that experienced private equity professionals are
not automatically better in recruiting a management team for their leveraged management buyout.
H2b is also therefore not supported.

Model 4 includes the interaction of experience and an involvement in strategic decisions. As
a result, the variance explained increases significantly (adj. R² change = 0.03, p<.1). In support of
H2c, the coefficient of the interaction term is positive and significant (p<.1). This suggests that if
experienced private equity professionals are involved, the relationship between a private equity
firm’s participation in the strategic decisions of the portfolio company and the value created is more
positive.

Model 5 adds the interaction of experience and involvement in operational decisions. The
interaction is not significant, but the direct effect of an involvement in operational decisions remains
significantly positive. This suggests that the relationship between the involvement in the operations of a leveraged management buyout and the value created does not depend on the experience of the private equity professionals. H2d is therefore not supported.

Finally, the full Model 6 assesses the joint impact of all four interaction effects. When taken together, none of the four interaction terms has any statistical significance, but the direct effect of an involvement in operational decisions remains significantly positive. One possible explanation for the fact that the interaction of experience and involvement in strategic decisions as well as the interaction of experience and involvement in financial management lose statistical significance could be the fact that experience enters once as a direct effect and four times through the interaction terms. However, given that VIFs are at 2.0 or lower, there is no harmful level of multicollinearity present (Mason and Perreault 1991).

In order to test Hypothesis 3 (that the effect of an involvement of PE firms is more pronounced for underperforming target companies at the time of acquisition), the sample was split into two parts. Given that study participants rated the average performance of portfolio companies at the time of acquisition at 4.51 on a Likert scale ranging from 1 (worse than competitors) to 7 (better than competitors), all portfolio companies with a performance at acquisition of 4 (same as competitors) or less, were attributed to the group of underperforming buyouts (descriptive statistics of all items used in this subsample are reported in Table 2b). Portfolio companies with a performance at acquisition higher than 4 (same as competitors) were attributed to the group of well managed target companies (descriptive statistics of all items used in this subsample are reported in Table 2c). We then repeated the previously described step-wise analysis in nested models.

Results of the multivariate regression analysis of the sample of outperforming portfolio companies (at the time of acquisition) can be found in Table 5. Interestingly enough, none of the
variables specified in our model has a significant impact on the performance of this sample of outperforming portfolio companies (at the time of acquisition). This is consistent with the prediction of our model that no positive parenting effect can be observed if the acquired unit does not have a particular need for parenting services.

Turning to the results of the multiple regression analysis of the subsample of underperforming portfolio companies (at acquisition) shown in Table 6 we see that here the effects are markedly different – two out of the four baseline effects are significant. The baseline effects of an involvement in operations and strategic decisions are positive and significant (p<.1 and p<.05, respectively). Of the interaction effects between experience and the other main effects analyzed in Models 14 to 17, the interaction between experience and finance shown in Model 14 is significant and positive (p<.1) just as with the overall sample. However, and contrary to the finding in the full sample, there is no significant impact of the interaction of experience and an involvement in strategic decisions on performance and a significant negative (p<.1) effect of the interaction of experience and an involvement in operations. The same effects also hold in the full model 18, where in addition we see a positive and significant effect of experience on buyout performance (p<.1).

Insert Tables 5 and 6 about here

In summary, whereas none of the main or interaction effects in the subsample of well-managed portfolio companies (at acquisition) are significant, two baseline effects and two interaction effects are significant in the subsample of underperforming portfolio companies (at acquisition). The results of this analysis suggest that the corporate parent – in this case, the private equity firm – may create value with underperforming portfolio companies in need of the specialist capabilities and resources of the corporate parent. This indicates support for Hypothesis 3. The
different, and somewhat counter intuitive effect of experience will have to be discussed in more
detail in the following section.

**DISCUSSION AND CONCLUSION**

So what does it take to be a good parent? This study aims to provide a better explanation for the
existence and performance of unrelated multibusiness firms. The starting point of our discussion
was the Penrosean notion that firms accumulate additional resources over time and whenever these
resources can be neither profitably used through an expansion of the scale of existing activities, nor
effectively sold over the strategic factor market, they drive firms to expand into new areas of
business. In the context of unrelated multibusiness firms, the focus is on headquarter resources that
are the origin of headquarter services provided by the corporate center to the business units. These
headquarter resources differ from business-unit level resources that are inherently linked to the
nature of the business unit’s activity, in that the relatedness between the business unit where they
were developed and the new area to which they are applied is not a helpful explanation for the
expected rents that they capture. Instead, the rent generating potential of available headquarter
resources, as we argue, depends on the need of a given business unit for the particular type of
headquarter service that they can provide.

From this theoretical discussion flows a model that specifies the conditions under which we
expect unrelated diversification to be value creating. The model specifies two important
contingencies for a positive parenting effect: first, the acquirer has to possess headquarter resources
and second, the acquired business unit has to need these headquarter resources. In other words, the
business unit’s performance can be substantially enhanced through the application of the
corresponding headquarter services. If we assume perfect competition in the market for corporate
control, these conditions become even stronger. Then, the acquirer has to be the best possible parent, in the sense that its headquarter resources increase performance and value of the acquired unit beyond what the second best parent (or acquirer) could and is willing to pay for the acquired unit.

To empirically test the model, we examined Leveraged Buyout (LBO) associations. This specific organizational form of unrelated multibusiness firms shares many important features with conglomerates (Baker and Montgomery 1994) and allows us to focus in on the performance impact of a specific parenting activity: the ‘vertical’ interaction between the private equity firm that constitutes the corporate center of the LBO association and the portfolio company acquired through the buyout that corresponds to a business unit in a conglomerate setting. In this context, we test specific hypotheses derived from our theoretical model regarding the performance impact of specific parenting activities performed by the private equity firm, and the moderating impact of: (a) experience of the private equity firm as a proxy for available headquarter resources; and, (b) the pre-buyout performance of the portfolio company as a proxy for the need of the acquired unit for the headquarter services offered by the private equity firm. Based on an OLS regression analysis of 101 European LBO associations with nested models, we find overall support for the key elements of our theory.

First, the analysis points to the need to refine Goold and Campbell’s (Campbell, Goold et al. 1995; Goold and Campbell 1998) original theory about the ‘parenting advantage’. Contingencies of the performance impact of parenting activities must be added, as in the entire sample of 101 buyouts, three out of PE firms’ four activities failed to show a significant impact on the performance of the portfolio company. The only parenting activity significantly and positively linked to buyout performance is involvement of the private equity firm in the operations of the
portfolio company. This is consistent with the view in the literature on buyout value creation (Berg and Gottschalg 2005; Kester and Luehrman 1995) that points to the importance of operational improvements through the buyout and to the private equity firm’s essential role in this process.

Our analysis further supports the view that parenting capabilities, approximated through the experience of the private equity firm, play an important role in this context, as they positively moderate the relationship between parenting activities and performance. While all private equity firms seem to be able to add value through an involvement in the operations of the portfolio company, only experienced ones do so also through an involvement in financial and strategic decisions. In both cases, the consideration of the interaction effect in the model significantly increases the explanatory power and fit of the OLS model.

Finally, our results are consistent with the predicted moderating role of the ‘need’ of the acquired unit for parenting services as a determinant of the performance of unrelated diversification. We split the sample into a subsample of portfolio companies that underperformed their competitors prior to the buyout, assuming that they had a greater need for the parenting services provided by the private equity firm, and a subsample of portfolio companies that outperformed their peers prior to the buyout. Our analysis reveals that none of the parenting activities has a significant performance impact in the sample of outperformers, not even when we consider the moderating role of private equity firm experience. With respect to the underperforming units with an expected need for good or better parenting, a very different picture evolves. First we note that two of the four parenting activities are now performance relevant, as an involvement in strategic and operational decisions significantly increases buyout performance irrespective of the experience of the private equity firm. It is interesting, however, to take a closer look at the direct and indirect effects of experience in the sample of initially underperforming portfolio companies. First, we see that in the full model (18)
there is a positive effect of experience on performance *per se*, indicating that experienced private equity managers are able to conduct better performing buyouts irrespective of the effect of individual parenting activities. With respect to the hypothesized moderating influence of the experience of the private equity firm on the performance impact of any of the parenting activities, we have to explain seemingly counter intuitive findings. While experience fails to show a statistically significant impact on the effect of an involvement in management recruiting or strategic decisions, its interaction term with financial involvements is significantly *positive* and with operational involvement it is significantly *negative*.

While this finding seems surprising at first sight, it is in fact consistent with other research on the effect of experience on capability development and performance. When it comes to complex organizational tasks, such as the management of acquisitions, alliances and restructuring processes, the intuitive assumption of a positive ‘learning-curve’ relationship between experience and capability development (Yelle 1979; Dutton and Thomas 1984; Epple, Argote et al. 1991; Argote 1999) does not always hold. In fact, the empirical evidence unearthed in several studies is inconclusive and in general does not support the learning-curve hypothesis. While some studies found a positive (learning-curve) effect of prior experience (Fowler and Schmidt 1989; Bruton, Oviatt et al. 1994; Pennings, Barkema et al. 1994; Barkema, Shenkar et al. 1997), other investigations found either no significant performance impact (Hayward 2002; Zollo, Reuer et al. 2002; Zollo and Singh, 2004) or a negative (Kusewitt 1985) or convex (Haleblian and Finkelstein 1999) effect. Two important contingency for the relationship between experience and capability development seem to be (a) the complexity of the task at hand and (b) the frequency with which these tasks occur. Experiences with simpler and more frequently occurring tasks seem to lead to a positive (learning-curve) effect, while the effect of experience with highly complex and rarely
occurring tasks tend to have the opposite effect.

If we apply these argument to the different parenting activities of private equity investors, we can explain the counter intuitive results of our analysis. According to prior research (see e.g. Berg&Gottschalg for an overview), operational changes are not only (relatively) more complex than improvements in the financial structure, but they also occur much less frequently. Hence the insight from the organizational learning literature that experience with highly complex and rarely occurring tasks tends to have a negative effect on performance can explain the negative effect of the interaction term between experience and operational involvement. Along the same lines this research would explain the positive effect of the interaction term between financial involvement and experience with the (relatively) lower complexity and higher frequency of decisions related to changes in the financial management that happen in a buyout context.

Jointly, these findings provide support for the key elements of the proposed theory of unrelated multibusiness firms. They support the role of specific processes of interaction between the corporate center and the business unit as the basis for the parenting effect, as well as the moderating impact of both the availability of headquarter resources of the corporate center and the need of the acquired unit as fundamental contingencies of the performance impact of any parenting activities.

Our findings also shed new light on the LBO phenomenon per se and particularly on the characteristics of the investing private equity firm as an important determinant of buyout value generation (Berg and Gottschalg 2005). First, they point to a set of distinct activities through which private equity firms try to add value: i.e. an active involvement in strategic, financial, recruiting and operational decisions. Second, they show that few of these activities can be expected to be value creating, irrespective of the characteristics of the acquiring private equity firm and the portfolio company. As mentioned earlier, only an involvement of the private equity firm in operational
decision processes has a positive and significant performance impact. This is consistent with the received literature on the importance of this value generation lever, which points to the relevance of operational improvements and the private equity firm’s role in this process (Kester and Luehrman 1995). Third our findings provide support for the commonly held belief in the private equity industry, that the experience of the private equity firm is a key determinant – if not even a predictor – of future performance. More specifically, they allow further insights into how this link between experience and performance comes about, as they show which of the private equity firm’s activities are more value creating when performed by an experienced private equity firm (financial and strategic management) and for which this does not seem to be the case (operational involvement). Furthermore, our results point to the need for private equity firms to recognize that their value creation ability crucially depends on the need, or prior performance, of potential portfolio companies. In fact, we find no indication of a positive performance impact of any activities of the private equity firm for portfolio companies that have not been performing worse than their industry peers prior to the buyout. Finally, this study provides support for the view that it may actually be optimal to limit the time companies remain in LBO associations’ portfolios. If private equity firms add value through their involvement in specific processes of the acquired entity and if we expect this to reduce the need for such an involvement over time, it may be optimal to divest the portfolio company after some time and to replace it with another unit to which the private equity firm’s parenting capabilities can be more profitably applied.

To the extent that these findings are indeed generalizable to non-buyout situations, i.e. diversified conglomerates, they may help us explain whether and when we expect conglomerate diversification to be value creating. Value creation depends on the distinct parenting capability of the corporate center. Conglomerate diversification in general can only be expected to be value
creating if the acquiring conglomerate is the ‘best parent’ in the sense that it provides the parenting services needed by the business units more effectively than all alternative acquirers. This study then has several important practical implications for managers of diversified multibusiness firms. First, these firms need to realize the nature of their (unique) parenting capability and understand the resources and processes that are its basis. Second, they need to assess realistically whether these resources are currently fully utilized or whether parenting resources are available. Only if the latter is true, should managers consider adding further activities to their firm by looking for targets of unrelated acquisitions that have a specific need for the parenting service they can offer. On the other hand, they should regularly revisit their portfolio of activities and determine whether they are still the ‘best parent’ for a given business unit and whether owning this business unit is the most effective way of extracting rents from (scarce) headquarter resources. Potentially, it may be valuable creating to withdraw from some activities where the corporate center no longer adds value and to acquire units where the headquarter resources can be more profitably applied. In a sense, conglomerates could learn from LBO associations that in some cases most value may be created through temporary ownership of a given unit.

All the previously discussed findings need to be interpreted, of course, in light of the limitations of this study, which at the same time point to several interesting areas for further research. Some of these are closely linked to the methodology of data analysis, measurement of variables and data collection. First, the methodology of data analysis adopted by this study, OLS regression, can identify only linear or quasi-linear relationships. That is, whatever relationships there may be between the parenting processes and the prior experience of the private equity firm, an OLS analysis will only be able to detect the linear or quasi-linear relationships between them. The experience of the private equity firm may, however, have a non-linear impact on the relationship
between involvement of a private equity firm and the resulting performance impact. Therefore further research analyzing the impact of experience on value added should use a methodology that permits the identification of curvilinear relationships. Second, in the survey instrument the experience construct does not account for costs incurred by private equity firms arising from its involvement. Additional professionals backing the involvement of a private equity firm should therefore be employed with prudence. Future research might analyze the impact on PE fund performance of additional private equity professionals in hands-on involvement strategies. Third, with regard to data collection, parenting was analyzed only from the point of view of private equity firms. Although a prior study has shown that there are no significant differences in responses provided by private equity firms and portfolio company executives (Sapienza, 1992), it cannot be excluded that this type of key informant bias may exist with regard to buyout investing. In order to exclude any potential key informant bias, further research should analyze the impact of the concepts of this study on value created from the portfolio company’s point of view.

In addition to these methodological factors, we need to keep in mind that despite all similarities between LBO associations and other unrelated multibusiness firms (Baker and Montgomery 1994), a number of idiosyncrasies remain in the buyout setting. These call for caution in transferring findings from this study to a conglomerate context. Future research is required to examine the conglomerate parenting effect with a perspective that is sharpened by the findings of this study. Its goal should be to identify the specific parenting processes in conglomerates and to link them to the specific resources and services provided by the corporate center. This could then form the basis of further empirical analysis addressing the question of whether and when unrelated diversification adds value in a conglomerate setting.
TABLE 1: Comparison of Organizational Forms of Conglomerates and LBO Associations (based on Baker and Montgomery 1994)

<table>
<thead>
<tr>
<th></th>
<th>Conglomerate</th>
<th>LBO Association</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition and diversification strategy</td>
<td>Regular acquisitions, high level of unrelated diversification</td>
<td>Regular acquisitions, high level of unrelated diversification</td>
</tr>
<tr>
<td>Capturing of synergies between BUs/portfolio companies</td>
<td>Few resource flows across BUs</td>
<td>Usually no resource flows across BUs</td>
</tr>
<tr>
<td>Divestitures</td>
<td>Usually no divestment</td>
<td>Divestment of portfolio companies at the end of limited partnership life</td>
</tr>
<tr>
<td>Structure of headquarters</td>
<td>Hierarchical structure: CEO presides over group vice presidents and headquarter staff</td>
<td>No formal structure: all associates report to all partners</td>
</tr>
<tr>
<td>Governance</td>
<td>Publicly traded companies with traditional management structures – rules of the game can be renegotiated with a phone call</td>
<td>Limited partnership structure with ownership of levered equity split among limited partners, general partners and portfolio company management – renegotiation of profit projections only at substantial cost</td>
</tr>
<tr>
<td>Control of the operating units</td>
<td>Measuring performance (profitability) and paying performance-based bonuses across all BUs, however, no divisional equity</td>
<td>Management equity ownership – illiquid during the holding period, however, objective valuation at sale</td>
</tr>
</tbody>
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### TABLE 2a: Descriptive Statistics (Full Sample)

<table>
<thead>
<tr>
<th></th>
<th>Minimum</th>
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### TABLE 2b: Descriptive Statistics (Underperforming Sample)

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### TABLE 2c: Descriptive Statistics (Overperforming Sample)

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### TABLE 3: Pearson Correlation Coefficients (N=101)

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* significant at the 0.10 level (2-tailed)
** significant at the 0.05 level (2-tailed)
*** significant at the 0.01 level (2-tailed)
TABLE 4: Multivariate Regression Analysis of Full Sample (N=101)

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(a) standardized coefficients; dependent variable is performance (mean = 0.00; std. dev. = 1.00)
* significant at the 0.10 level (2-tailed)
** significant at the 0.05 level (2-tailed)
*** significant at the 0.01 level (2-tailed)

TABLE 5: Multivariate Regression Analysis of Portfolio Companies Performing Well at Acquisition (N=55)

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(a) standardized coefficients; dependent variable is performance (mean = -0.43; std. dev. = 0.89)
* significant at the 0.10 level (2-tailed)
** significant at the 0.05 level (2-tailed)
*** significant at the 0.01 level (2-tailed)
TABLE 6: Multivariate Regression Analysis of Portfolio Companies Underperforming at Acquisition (N=45)

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<tr>
<td>Maximum VIF</td>
<td>1.9</td>
<td>1.9</td>
<td>1.9</td>
<td>1.9</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.36**</td>
<td>0.42**</td>
<td>0.34**</td>
<td>0.36**</td>
<td>0.42**</td>
<td>0.47**</td>
</tr>
<tr>
<td>Adjusted R² change</td>
<td>n.a.</td>
<td>0.06**</td>
<td>-0.02</td>
<td>0.00</td>
<td>0.06**</td>
<td>0.11*</td>
</tr>
<tr>
<td>Sign. of R² change relative to model</td>
<td>n.a.</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
</tr>
</tbody>
</table>

(a) standardized coefficients; dependent variable is performance (mean = 0.52; std. dev. = 0.88)
* significant at the 0.10 level (2-tailed)
** significant at the 0.05 level (2-tailed)
*** significant at the 0.01 level (2-tailed)

FIGURE 1: Taxonomy of Diversification Levels

Single business firm         Multibusiness firm
                             
                             Related diversifier       Unrelated diversifier
                             
                             Conglomerate                LBO association
FIGURE 2: Theoretical Model

Availability of Headquarter Resources

Specific Parenting Activities

Value Creation

BU's Need for Headquarter Services

FIGURE 3: Empirical Model

Experience of Investment Managers

Involvement of the PE Firm in
- Financial Management
- Strategic Decisions
- HR Recruiting
- Operations

Pre-Buyout Performance of Target Company

Buyout Performance

Controls:
- Year
- Industry Sector
- Deal Size etc.
FIGURE 4: Responding Private Equity Firms by Country

REFERENCES


