The Capital Structure of Private Equity-backed Firms

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Abstract

This paper presents a model of capital structure of private equity-backed firms. It proposes a novel rationale for using outside financing in private equity investment. Private equity investment at the deal-level is characterized by a financing structure that private equity fund’s own capital is complemented by outside financing, even though the fund may not be financially constrained at the deal-level. I show that this special arrangement of financial structure is a mechanism that can resolve the tension between management (entrepreneur)’s effort and the lack of commitment by the venture capitalist about her exit or continuation/liquidation decision. Due to the external uncertainty involved in a private equity project, maximizing project value typically requires the venture capitalist’s commitment to continue the project inefficiently ex-post, which can better provide incentives to management ex-ante. However, under pure inside financing, the venture capitalist lacks a mechanism to commit to such an ex-post concession and project value is not maximized. I show that capital structure with outside financing is a mechanism that can induce commitment and hence maximizes project value. The model offers several novel empirical predictions. The insight of the paper has applications outside of private equity investment.