You can make the jump, but can you stick the landing?

Private equity goes international

M&A Research Centre – MARC

May 2017

MARC – Mergers & Acquisitions Research Centre

MARC is the Mergers and Acquisitions Research Centre at Cass Business School, City, University of London – the first research centre at a major business school to pursue focussed leading-edge research into the global mergers and acquisitions industry.

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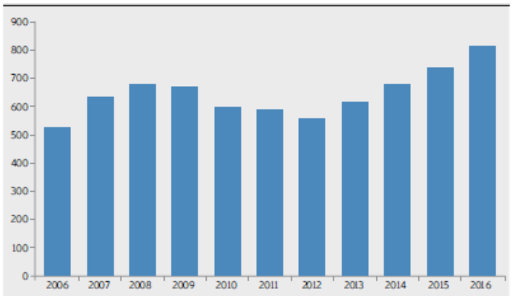
Overview

At the end of 2016 private equity (PE) firms had a record $822 billion in ‘dry powder’. This was despite 2016 representing a five-year high in PE buyouts.

Figure 1: PE dry powder ($bn), (Preqin)



So if you are working in PE how are you going to spend all this ‘powder’?

Particularly if you are in the developed markets of the US and the UK, the maturity of the markets, the extent of the increased indebtedness of corporates and the intensity of competition for assets means domestic opportunities are limited. But if you go cross-border can you exit?

Naturally, exiting is key: it’s a necessary but not sufficient condition for success. PE funds have limited contractual lifetimes, exit isn’t a choice, it’s often a requirement. Given the incompleteness of PE return data, particularly on a global level where we could only obtain internal rates of return (IRR) for 10% of cross-border deals, we focus on the obtaining of an exit, the timing of such an exit and the form of the exit as proxies for success.

Most previous studies have either focussed on early stage venture capital performance or PE behaviour in domestic markets. Specifically, most PE studies shed light on the US and European markets (see Appendix for the geographic split of our database). This paper covers not only mature markets but also emerging markets such as China and India.

When PE firms invest abroad, they face an unfamiliar environment and the information asymmetry could be severe. This environmental ‘distance’ can adversely affect investment performance. However, PE firms can accumulate mitigating experience, including cultural knowledge, institutional technical knowledge and cross-border transaction knowledge in their on-going activities and overcome institutional barriers. We analyse the impact of institutional, cultural and organisational learning factors on the likelihood of successful exits. We look at both probability of successful exits and the time to exit. We also test the impact of the chosen factors on the choice between IPO and M&A as exit routes.

Given the growing (see overleaf) significance of cross-border buyouts, which factors predict the eventual exit of such a buyout? And do these factors have an impact on the specific exit strategy? These questions have not been answered in the PE literature before now.

As the CIO of a PE firm sitting on a record amount of ‘dry powder’, with limited domestic options, what does the data say?

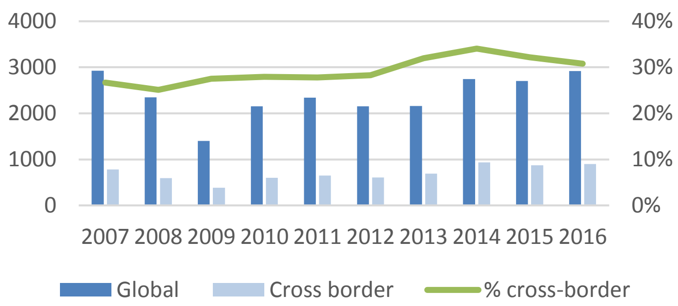
1. A good starting point is to screen the globe for political, economic and financial stability factors.
2. Do keep your atlas beside you, geography matters.
3. Looking at your business, you can take more risks if you’ve gone cross-border before and know the industry. Don’t worry much if you haven’t invested in that country before.
4. Some will worry about cultural fit with a foreign deal. If you have the right experience, you can largely ignore them.
5. If you can wait and want the ‘big-win’, by all means call your fellow CIOs and go for a joint deal with IPO exit.
6. If you want a high likelihood of exit, but don’t envisage an IPO, then try to get management involved.

What was known

Rossi and Volpin (2004)[1] find that the country-specific legal environment is the key determinant of merger and acquisition activity and that cross-border M&A plays a role in governance enhancement. This paper extends the legal study to the broader theme of institutional environment and the M&A theme to LBO performance.

Lerner et al. (2009)[2] show that LBO outcomes and exit ratios (both domestic and cross-border deals) vary across different countries, with the highest exit ratio in the North American market and the lowest in developing Asian markets. Their evidence suggests that there are important country-specific factors facilitating successful buyout exits. This is on top of the established literature establishing that there are non-specific industry-wide deal factors that can drive performance. For example, Alperovych et al. (2013)[3] find that PE experience exerts a positive influence on post-buyout efficiency during the first three years after the buyout.

Figure 2: Buyouts by number (Source: Mergermarket)



Moving to the factors similar to those we investigated, Nahata et al. (2014)[4] find that superior legal rights and better-developed stock markets significantly enhance performance.

Somewhat remarkably, they find that cultural distance increases the likelihood of successful exits and they argue that venture capital managers recognise the cultural distance and conduct the due diligence and screening more carefully. You will see later in this report that we do not find such a linkage but equally we do not find for the opposite, more likely on the face of it, proposition. Turning to geography, Chemmanur et al. (2014)[5] find that US investors have a higher likelihood of successful exits and the presence of an open sky agreement between US and target countries is positively related to the likelihood of successful exits.

This paper differs from the previous literature in several perspectives. The focus will be at a deal-level and on exit likelihood. We construct a sample of the investment details, including the exit outcome tracking record, of more than 1,000 PE firms. Most of the recent studies investigate venture capital investment or cross-border investment of US PE investors. Non-US investors are becoming more important over time, and as such, it is well worth considering the cross-border investments of non-US PE investors.

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[1] Rossi, S. and Volpin, P.F. Journal of Financial Economics

[2] Lerner, J., Sorenson, M. and Stromberg, P. Working Paper

[3] Alperovych, Y., Amess, K., and Wright, M. European Journal of Operational Research

[4] Nahata, R., Hazarika, S. and Tandon, K. Journal of Financial and Quantitative Analysis

[5] Chemmanur, T.J., Hull, T.J. and Krishnan, K. Working paper

What we investigated

We divided the potential drivers of exit success into three categories: target country characteristics, deal characteristics and buyer learning (see Figure 3 for detailed definitions and sources of variables).

Target country characteristics

Institutional environment

We calculate a country composite index for the location of each buyout target. Within the index calculation, political risk components account for 50% and the rest consists of economic and financial risk, with equal weight. Low-risk countries are defined as those with a composite rating higher than 80 points while high-risk countries are those with a rating less than 50 points.

Legal framework

There are two contrasting views on the effects of the law and legal institutions on financial transactions. Under the "law matters view", La Porta et al. (1997, 1998)[6] show that a strong legal system exerts a positive influence on investor protection and capital markets development. Under the "Coasian view", the legal and institutional differences do not matter as sophisticated investors can privately negotiate and optimize the contract to mitigate the legal impediments. For example China has an underdeveloped legal and financial system but the legal impediments do not seem to have prohibited China's rapid growth.

Compared to previous studies which focus on the legal system and its origins, contract enforcement and creditor rights separately, we use the time-varying country composite index above to capture the overall impact of institutions on the success of a buyout. This index takes the political risk, economic stability and financial stability into consideration. The higher the index score, the lower the risk of the country and the better the institutional environment. As an additional test, we construct a legal index and measure the relative contribution of the law to the cross-border buyout success (see Berkowtiz et al. (2003)[7]).

Cultural distance

Deal negotiation, contract negotiation, corporate policy design and working relationship development could be affected by cultural factors such as individualism, uncertainty avoidance and gender equality.

To capture the effect of cultural differences, we adopt Hofstede's cultural distance analysis. In his seminal 1980 book 'Culture's Consequences: International Differences in Work Related Values', he emphasises the influence of culture on society and economic development. There are four dimensions in his cultural evaluation: power distance, individualism, masculinity and uncertainty avoidance. We measure the cultural distance between the country of the lead PE firm and that of the portfolio company.

Geographic distance

Despite advances in transport and other technologies, and the existence of global trading agreements, international trade is still directly linked to geographic distance, with a rule of thumb that if you double the distance you halve the trade. With that in mind it is unsurprising that geographic proximity could favour the involvement of nearby PE firms with the portfolio company and improve the performance. We measure the geographic proximity by using the geographic distance between the central city (in terms of population) of the portfolio company's nation and the lead PE firm's nation.

[6] La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R. Journal of Finance, Journal of Political Economy

[7] Berkowitz, D., Pistor, K., Richard, J.F. European Economic Review

Deal characteristics

Management involvement

With the management team participating in the buyout transaction, the information asymmetry between the PE firm and the target company could be reduced and hence better performance is anticipated. To account for corporate governance characteristics, we set the 'Management Participation' variable equal to one if the deal is defined as "management buyout" in Mergermarket, "acquirer including management" in SDC Platinum M&A database, or "management buyout" in Zephyr.

Club size

In order to control for syndication among PE firms, the variable 'Club Size' is included. Officer et al. (2010)[8] demonstrate that PE clubs pay less for the buyout transaction and such lower pricing might be a by-product of a motivation for club deals. Meuleman and Wright (2011)[9] find that institutional differences induce UK PE firms to cooperate with a local PE firm when they invest in continental Europe. The variable Club Size is calculated as the number of PE firms in the deal.

Buyer Learning

Country experience

We measure this variable as the number of buyouts which the PE firm completed in the country of the portfolio company from 1990 to the year prior to the initial buyout.

Multinational experience

As cross-border investments can be considered as part of the internationalisation process, multinational experience around a rich array of environments, with a broad array of institutional characteristics, can also play a vital role in the PE process. The knowledge of the local institutions and historical cross-border transactions could mitigate the information asymmetry created by institutional barriers, reduce the transaction complexity and thus facilitate the exit process.

Multinational experience is constructed by the number of foreign countries in which the PE firm invested from 1990 to the year prior to the initial buyout.

Industrial experience

The next variable, industry experience, aims to capture the industrial specialisation as each PE firm often has its own industry focus. PE industry experience is calculated as the number of buyouts which the PE firm completed in the industry of the portfolio company from 1990 to the year prior to the initial buyout.

Reputation

As PE firms approach the buyout market repeatedly, building reputation is a necessity because reputation can serve as certification and help to mitigate the information asymmetry between PE firms and potential buyers. Previous studies suggest that reputation helps PE firms to be offered more deals, obtain more favourable terms and facilitate the exit process. Specifically, Stromberg (2008)[10] showed that, in the US market, experienced PE firms divest their portfolios companies more quickly.

We construct another variable, Reputation, measuring recent experience: the total number of buyout transactions completed by the PE firm three years prior to the time the PE firm first invested in the portfolio company.

[8] Officer, M.S., Ozbas, O. and Sensoy, B.A. Journal of Financial Economics
[9] Meuleman, M. and Wright, M. Journal of Business Venturing
[10] Stromberg, P. Working Paper

Figure 3: Variable definitions and categorisations

Variables	Definition and Source	Segmentation for probability calculations (see Figure 4)
Target Country Characteristics		
Country Index	Logarithm of the composite index. The composite index consists of political risk with weight 50%, economic stability with weight 25% and financial stability with weight 25%. (Source: International Country Risk Guide)	Low risk: Country index >80.
Legal Index	Legal Index = 0.381*(Efficiency of Judiciary) + 0.5578*(Rule of Law) + 0.5031*(Corruption) + 0.3468*(Risk of Expropriation) + 0.3842 * (Risk of Contract Repudiation). (Source: La Porta et al., 1998)	Change of 1 standard deviation in the legal index.
Cultural Distance	Cultural distance between the target company's and the lead PE buyer's nations. It is measured as the distance between Hofstede's four-dimensional cultural factors on time-varying meta-analytic scores: power distance, individualism, uncertainty avoidance and masculinity. (Source: Taras et al., 2011[11])	Familiar country if distance between target and acquirer is in the smallest quartile group.
Geographic Distance	Logarithm of geographic distance between the central city (in terms of population) of the country of the PE firm and the country of the portfolio company. (Source: CEPII)	Change of one percentage in the geographic distance.
Buyer Learning		
Country Experience	Logarithm of one plus the number of buyouts which the PE firm completed in the country of the portfolio company from 1990 to the year prior to the initial buyout. (Source: Mergermarket and SDC Platinum M&A database)	Familiar country if the country experience of a PE firm in the year prior to the buyout transaction belongs to the largest quartile group.
Multinational Experience	Logarithm of one plus the number of foreign countries in which the PE firm invested from1990 to the year prior to the initial buyout. (Source: Mergermarket and SDC Platinum M&A database)	Experienced if the multinational experience of a PE firm in the year prior to the buyout transaction belongs to the largest quartile group.
Industrial Experience	Logarithm of one plus as the number of buyouts which the PE firm completed in the industry of the portfolio company from 1990 to the year prior to the initial buyout. (Source: Mergermarket and SDC Platinum M&A database)	Deemed experienced if the industrial experience of a PE firm in the year prior to the buyout transaction belongs to the largest quartile group.
Reputation	Logarithm of one plus the number of buyouts completed by the PE firm three years prior to the initial buyout. (Source: Mergermarket and SDC Platinum M&A database)	Deemed to have a good reputation if the reputation of a PE firm in the year prior to the buyout transaction belongs to the largest quartile group.

[11] Taras, V., Steel, P. and Kirkman, B. L. Journal of World Business

Figure 3 cont: Variable definitions and categorisations

Variables	Definition and Source	Segmentation for probability calculations (see Figure 4)
Deal Characteristics		
Management	Indicator variable which equals to one if management participates in the buyout transaction. (Source Mergermarket, SDC Platinum M&A database, and Zephyr)	Probability improvement from management involvement.
Club Size	The number of PE firms in the club deal. (Source: Mergermarket, SDC Platinum M&A database, and Zephyr)	Probability change given one more PE firm in the PE club.

Source: Cass Business School

Note: Danger of confusing cause and effect

Before we consider our analysis and results we should note that the results of analyses on the successful exits could produce biased results if we ignore the possibility that the performance is not due to the experience (for example) of PE firms but the selection of high quality portfolio companies. It is important to control for the selection bias associated with PE firms' choices of their portfolio companies. We find that after controlling for this selection bias the results you will see below are robust.

Our analysis

Likelihood of exit

We follow the benchmark literature by Stromberg above and adopt an eight-year window over which to observe an exit. Given the median holding period of around five years (see Figure 6) we consider this appropriate, also bearing in mind the contractual rules by which funds operate in terms of returning proceeds. An exit beyond eight years would not normally be regarded as a 'success' through much of the term of the period analysed.

Our results are shown in Figure 4 below. We show the significance of any relationship with exit likelihood together with the percentage change in exit likelihood from being in the variable's selected state.

We find that in all specifications, the country index has a positive impact on cross-border buyout probability of exit, consistent with the hypothesis that the quality of institutional environment can help to facilitate the exit process and the "law matters view".

The coefficient of cultural distance is insignificant and PE firms which are sophisticated investors suffer from minimal adverse influence of cultural differences. The result is different from Nahata et al. (2014), as mentioned above, who report a positive influence of the cultural distance on venture capital performance. Compared to venture capital firms, PE firms typically conduct LBOs in the later stage and around mature firms which can generate enough operating cash flow to repay the debt. Consequently, one plausible explanation for this finding could be that the sophisticated buyout specialists rely on the hard cash-flow data and thus overcome the cultural distance barrier.

Probably unsurprisingly, PE firms' experience and reputation positively impact on exit performance. Specifically, multinational experience (which introduces the knowledge of different institutions), industrial experience (which can offer operational insights) and reputation (which can serve as certification to resolve asymmetric information issues), help PE firms achieve a higher likelihood of successful exit in a cross-border buyout.

We also find that management participation, which reduces the information asymmetry, between the 'insiders' and 'outsiders' in a PE transaction helps to improve the likelihood of exit.

In terms of club size, we find diseconomies of scale in that the larger PE group takes a longer time to successfully divest the portfolio company. However, we will later find that larger club size is positively associated with the likelihood of an IPO and negatively associated with the likelihood of M&A. Although PE firms most frequently adopt M&A to divest portfolio companies, IPO is considered by many as the most successful method (Gompers, 1996)[12]. Combining these results, larger clubs can still be viewed as making a positive contribution to cross-border buyout performance.

Looking at geographic distance, we find evidence that PE firms are less likely to exit successfully if they are far away from their portfolio companies.

Finally, and separately from using the composite country index, we consider the legal index. Consistent with the legal and finance literature, we find that the legal index is positively related to the likelihood of successful exit. The result indicates stronger contract enforcement, better investor protection and well-developed legal systems, which generally reduce the transaction information asymmetry and complexity, are beneficial to cross-border buyout performance.

Overall, the analytical results indicate the probability of successful exit increases when the quality of the institutional environment and legal system is higher and when PE firms have more international experience, industrial

[12] Gompers, P. Journal of Financial Economics

experience, and reputation certification. In addition, sophisticated LBO specialists suffer less from cultural differences. These findings support the "law matters" and "experience matters" hypotheses.

As is often the case the results on which drivers do not have a positive impact are at least as interesting as those that do. In this case, we would flag the aforementioned comments on cultural distance and also the lack of impact of country experience. It seems that it is more important to gain experience in your industry, in any buyout deals and in going cross-border generally than to have had experience of the target country specifically.

Figure 4 Impact of variables on the likelihood of exit within eight years

Target Country Characteristics	**Change in probability & significance**
Country index	13.5%***
Legal index	5%**
Cultural Distance	-
Geographic distance	-2%***
Deal characteristics	
Management involvement	8.7%***
Club size	-2.2%**
Buyer learning	
Multinational experience	11.3%***
Industrial experience	11.0%***
Reputation	9.7%***
Country experience	-

Source: Cass Business School. ***, **, - stands for significance level at 1%, 5% and no significance respectively. Interpret the figure as the increase in probability of exiting within eight years from being in the 'beneficial' category of the variable or for a shift of 1 unit in the variable (see Figure 3).

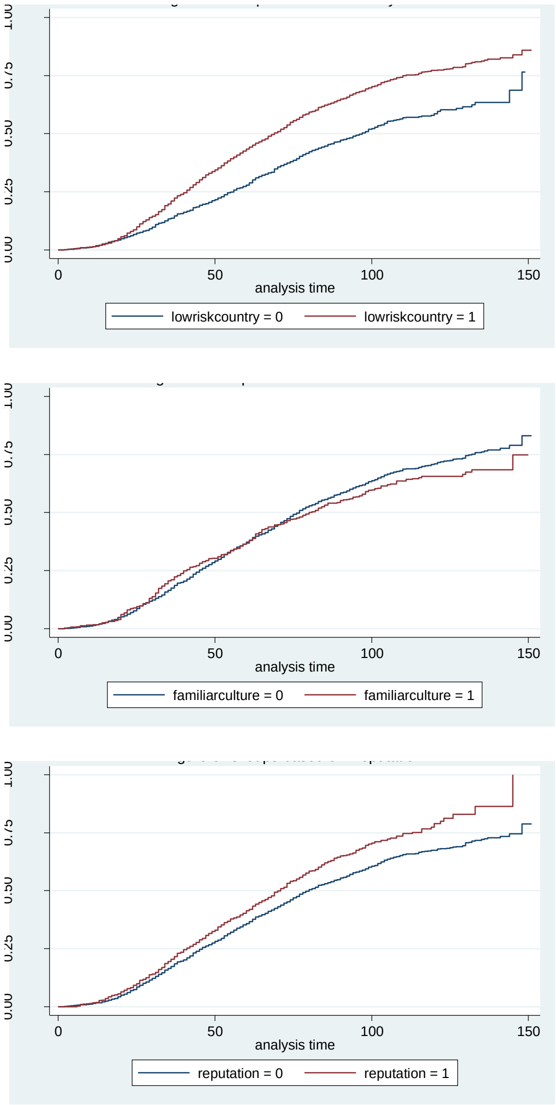
Time to exit

We then undertook the natural extension of this work to consider how the length of time to exit was influenced by the above factors. In themselves the results don't add a great deal to the learnings (in that the factors increasing the chance of exit within eight years also reduce the expected time to exit), but they do confirm that the relationships do not have 'key years' or breaks where there is a factor that increases the chance of an exit, but only in, say, year six.

We would particularly highlight the longer time of exit of larger PE clubs, likely linked to deal complexity and the need for agreement over exit price and strategy.

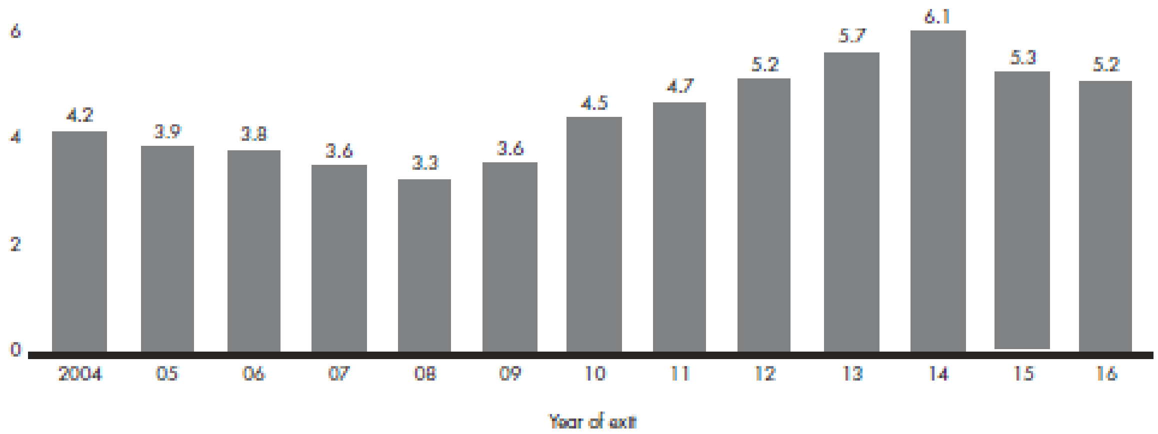
This analysis also allows us to show graphically the development of the cumulative probability of exit based on the factors studied. We show three of the examples in Figure 5. Note again the lack of impact of cultural distance. It is also interesting to compare the times shown with the industry level exit time data in Figure 6.

Figure 5: Model derived cumulative exit probabilities (months) for country risk, culture and reputation



Source: Cass Business School

Figure 6: Median holding period for buyout backed companies (Source: Preqin)



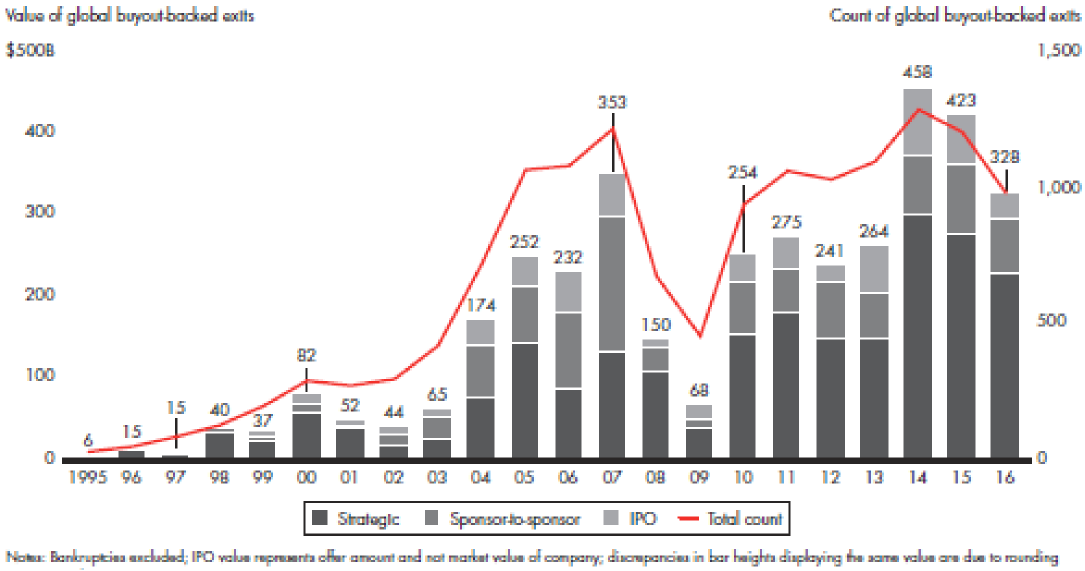
How will you exit?

Using similar tools as above and the factors we have chosen to investigate, we can quite easily also look at what drives the decision on exit route. We find that the decision between IPO and M&A mainly depends on the deal characteristics. The involvement of a management team generally leads to the merger and acquisition route rather than an IPO. This is perhaps owing to a desire for more definite future involvement and a desire to not concede control, once having gained it.

The data also suggests that the larger the PE club size, the higher the likelihood of going IPO. This is a 'good thing' in the sense that IPO exits are associated with higher returns (see above), but bear in mind that these larger PE clubs typically take longer to exit, as also mentioned above.

Below in Figure 7 we show the industry level data on the form of exit.

Figure 7: Form of exit from buyouts



Source: Dealogic

Conclusions

This study examined the determinants of cross-border buyout performance, specifically the ability to exit, focusing on the country-specific, cultural and learning factors. We used the Mergermarket database and obtained 2,665 cross-border buyout transactions in 40 countries and regions from 1998 to 2007. To study the likelihood of successful exits, we first analysed if PE firms could exit their portfolio companies via IPO or via takeover in an eight-year window. We then examined the determinants of the time to exit, and unsurprisingly the results were consistent with the first tests. We conducted additional analyses to examine the impact of chosen success factors on the choice between IPO and M&A.

We find that the quality of the institutional environment is positively related to the likelihood of successful exits. Furthermore, and perhaps surprisingly, cultural distance does not play a role in cross-border buyout performance. However, a high quality legal environment plays a positive role independent of the more general institutional environment. While unlike cultural difference, geographic distance is negatively correlated with exit success. Despite modern communication tools, multinational financial bodies and the diverse geographic spread of the major trading nations' physical location still matters to a perhaps surprising degree.

We then measured the impact of 'learning' from four angles: country-specific experience, multinational experience, industry experience and reputation. As one might expect we find that in general experienced PE firms perform better. However, interestingly, prior experience in the target country does not play a role.

In the additional analysis on the choice of exit route, larger PE groups are positively associated with the choice of IPO as the exit route but negatively associated with the choice of M&A. So, with larger syndicates you make your choice, a longer wait, but perhaps for an IPO, an exit method typically associated with higher returns. In almost a mirror image, having management involved in the buyout increases the chances of exit but tends to lead to that exit being via the M&A, as opposed to IPO route. We summarise our findings in Figure 8 below.

Figure 8: Summary of variables' impact on exit probabilities (Source: Cass Business School)

	Impact on probability of exit
High quality of target country institutional environment	Positive
Quality of legal system	Positive
Cultural distance	No significant impact
Syndication size	Negative (and higher probability of IPO exit)
Management involvement	Positive (and higher probability of M&A exit)
International experience of buyer	Positive
Greater industrial sophistication of buyer	Positive
Reputation of buyer	Positive
Country experience	No significant impact
Geographic distance	Negative

Appendix

The sample of global LBO was obtained from the Mergermarket database, a data provider for merger and acquisition transactions. Mergermarket tracks investment records for 1,008 worldwide PE firms (as of 31st December 2015).

We included buyout transactions from 1 January 1998 to 31 December 2015 and exclude the countries with less than ten observations to avoid the adverse effects of outliers. We then tracked the outcomes of all buyout transactions until the end of 2015 and there is an eight-year window left for the exit. The sample thus yields 2,665 deals from 40 countries from 1998 to 2007.

Temporal Distribution

Distribution of buyouts and exit types by year. The buyout sample includes 2,665 worldwide buyouts from 1998 to 2007. The sample is extracted from Mergermarket.

Year	Successful exits			Unsuccessful exits			Total
	IPO	M&A	Sub total	Other exits	Non-exit	Sub total	
1998	2	75	77	8	11	19	96
1999	10	107	117	7	15	22	139
2000	6	117	123	11	13	24	147
2001	5	86	91	7	21	28	119
2002	7	117	124	12	20	32	156
2003	11	137	148	12	25	37	185
2004	14	205	219	19	66	85	304
2005	17	253	270	24	123	147	417
2006	23	272	295	39	221	260	555
2007	15	234	249	41	257	298	547
Total	110	1,603	1713	180	772	952	2,665

Target Countries

The distribution of buyouts and exit types by target countries. The sample includes 2,665 worldwide buyouts across 40 target countries and regions. The sample is extracted from Mergermarket. We show here the ten countries that have the most frequent buyout transactions and present them according to the descending order of frequency in the number of buyouts.

Target Country	Successful exits			Unsuccessful exits			Total
	IPO	M&A	Sub total	Other exits	Non-exit	Sub total	
Germany	10	251	261	19	48	67	328
UK	12	160	172	16	89	105	277
France	4	183	187	17	56	73	260
US	7	104	111	19	54	73	184
India	4	47	51	15	73	88	139
Netherlands	7	81	88	11	36	47	135
Italy	3	88	91	7	32	39	130
Sweden	9	73	82	4	30	34	116
China	16	21	37	9	56	65	102
Canada	5	44	49	7	40	47	96

PE buyer countries

The distribution of buyouts and exit types by PE company country. The PE firms are from 42 countries and regions. The sample is extracted from Mergermarket. We show here the ten countries that have the most frequent buyouts transaction and present them according to the descending order of frequency in the number of buyouts.

PE Country	Successful exits			Unsuccessful exits			Total
	IPO	M&A	Sub total	Other exits	Non-exit	Sub total	
US	48	513	561	58	332	390	951
UK	40	590	630	51	149	200	830
France	5	68	73	12	21	33	106
Australia	1	43	44	9	43	52	96
Netherlands	1	59	60	4	16	20	80
Sweden	3	49	52	4	18	22	74
Hong Kong	2	29	31	5	29	34	65
Bahrain	1	44	45	7	9	16	61
Germany	0	30	30	6	9	15	45
Singapore	1	10	11	4	27	31	42

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Cass Business School
In 2002, City University's Business School was renamed Sir John Cass Business School following a generous donation towards the development of its new building in Bunhill Row. The School's name is usually abbreviated to Cass Business School.

Sir John Cass's Foundation
Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.