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SECOND HAND, SECOND RATE?

Once considered the exit route of “last resort”, secondary buyouts are now an established part of the private equity landscape – for both sellers and buyers. But what motivates firms to sell to another private equity house? And how does this type of investment perform? We discuss this with three academics and two practitioners.

Chaired by Lisa Bushrod.

Over the past five years, the prominence of secondary buyouts (SBOs) has grown as both a source of exits and a new deal flow: they now account for almost half of PE's portfolio realisations. Yet they are not always popular with LPs, which have long complained about paying both exit and (re)entry fees amid concern about how this affects their overall portfolio performance.

Three recent academic studies explore the motivations for choosing SBOs – both as a source of investments and as a source of exit route. They also address the relative financial returns of SBOs as an investment vehicle. One study finds that funds under pressure are more likely to complete more SBOs on both buy- and sell-side, and that those SBOs often underperform primary buyouts; another finds that SBOs made at the end of an investment period underperform those made early in a fund's life; and the third suggests that debt and capital markets activity influences SBO activity. So does this mean that LPs should be concerned? And what is the GP perspective on this type of deal? Three of the authors of the research and three practitioners debate the issues.

Zsuzsanna, your paper looks into agency issues in SBOs. Can you explain what you found?

Fluck: “Most partnership agreements set the management fee, which provides the budget of PE funds, at 2% of the committed capital for the investment period of the fund. After that, management fees usually change to 2% of only what has been invested. This can create an adverse incentive to say: ‘Ok, you should invest whatever you can.’”

“Our research found that pressured buyers – PE funds late in the investment period with a lot of dry powder, with a less-established reputation and with less-frequent fundraising activities – are more likely to do SBOs, pay higher multiples and use more equity in their deals.”

Jenkinson: “Whether PE funds sell to each other rather than holding on to the company for a lot longer, that comes down to agency issues. It is the IRR versus money-multiple tension. The way the funds are structured means that firms seek a high IRR on a quick exit instead of earning more on the money-multiple. But, as the old saying goes, investors can't eat IRR.”

So what are the “right” motivations for choosing to do an SBO?

Degeorge: “The most obvious difference [between primary buyouts and SBOs] is that it is easier to source an SBO than a primary buyout. It can take a lot longer to convince a

family or a conglomerate to sell. And in these situations, adverse selection comes into play; this is the notion that if you are a buyer and you convince a family or conglomerate to sell, you might end up with the lemons. This is less of a problem in the case of PE sellers because they buy companies to sell so they are always sellers by definition. But for repeat buyers, because they are repeat buyers, they may be concerned about reputational issues.”

Wilson: “I think motivations have much to do with the different development stages a business goes through. Businesses can get to a point where they outlive their current sponsor. They might need a sponsor with more firepower or with experience of helping businesses expand internationally. In those scenarios, an SBO is the logical next step.”

Fluck: “I agree. Some SBOs do add value by contributing different skills to the leveraged buyout restructuring process. They make operational and financial changes to a business, realise returns and pass it on to the next PE sponsor. Pressured PE funds, however, are more likely to do SBOs for agency reasons.”

Lo: “In Asia, because the funds are set up in the Western format, GPs are incentivised by the same methods and structures. So we think that the general direction of the market should evolve in a similar way. PEs will not rely on or prefer IPOs as an exit path forever; we expect

them to evolve like Western GPs towards trade or secondary sales as preferred exit routes.”

Would you say that the growth of SBOs is more the result of preference or of circumstance?

Jenkinson: “The sort of press SBOs have had is a bit unfair. For the exiting fund, they can make perfect sense. But you do find that the state of the credit markets and equity markets is the most significant determinant of exit route.”

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Zsuzsanna Fluck,
Michigan State University

“LATE SECONDARY BUYOUTS ARE THE ONES THAT ARE POTENTIALLY PROBLEMATIC; THEY ARE AN EASY WAY TO USE CAPITAL IF A FUND IS A LITTLE LATE TO SPEND THE CASH. WE ARE LOOKING AT A LARGE DIFFERENCE IN PERFORMANCE”

*François Degeorge,
University of Lugano*

Fluck: “That’s similar to what we found. We have about 30 years of data to look at, so we studied the changing macro conditions over that time. We found more SBOs at times when leverage was cheap and more SBOs when IPO markets were not welcoming or were cold.”

And to what extent do the managers of PE-backed companies drive the choice of exit?

Degeorge: “The choice of exit route depends a lot on market conditions. For example, SBO exits tend to be favoured compared with trade sales when credit conditions are favourable. On average, SBO sellers have done well. Where an SBO exit has been chosen, the managers of the target company may have some influence at the margin on the choice of buyer. They may lean towards a PE firm that they feel comfortable working with.”

Wilson: “I’d say that the relative attractiveness of an SBO depends on a number of factors, including the macro environment, specific industry dynamics and stage of development of the business, as well as the aspirations of the managers. For

example, if a company plans to grow internationally or enter a particular market, then the managers may prefer to execute that plan with the support of a PE house with experience in that specific market.”

So are SBOs the least risky option for buy-side and sell-side?

Degeorge: “It is very hard to measure risk in PE, and trying to do so would open a whole can of worms. Nobody really has a good solution to the problem of measuring risk. If you look at systematic risk, it is not at all clear that SBOs are less risky. There is no evidence that they are less risky than primary buyouts.”

Gardella: “In an SBO transaction, you pay a high price for a well-performing company. If the company does not continue on the same trajectory, the riskiness of the investment will increase if you have paid a full price and leveraged the deal as far as you can, and there may not be many ways to improve the business to create an attractive PE return. Meanwhile, with an underperforming business or a turnaround situation, there may be a real opportunity in addressing the issues facing the company.”

Jenkinson: “On the sell-side, I don’t think there is necessarily a natural pecking order for exits. Academic literature tends to see IPOs as the best exit. Yet the IPO is not, in general, a very attractive exit route for the GP. When it comes down to it, in general, GPs prefer to go through an auction with trade buyers and PE firms. PE funds want the highest and most certain amount of money. That often comes from a PE player who can benefit from higher leverage and get the tax benefit of leverage. And there are no competition issues with PE investors.

“Overall, PE firms feel that SBOs give a much higher degree of control than trying to take a company public. I don’t think the IPO is the first choice for most PE funds. I think it’s probably the exit of last resort, rather than first resort.

“Yet there are some companies, such as Facebook, that are too successful to exit via trade or SBO; if you are going to exit, you have to do an IPO. In a way, IPOs are the only exit for these types of companies. However, exiting through an IPO brings uncertainty: you don’t know what you will ultimately get for those shares when you sell them.”

Lo: “PE investors prefer to do trade sales and secondary sales because they just hate the uncertainty of the IPO market. Whereas in the Asian markets, for the past 15 years in which PE has been in existence, it has predominantly relied on IPOs as an exit route. Now Western PE has developed to a degree where PE managers are in the driver’s seat; by which I mean they make control investments [buyouts], and as the control shareholder they can effect the sale of the whole company.”

So the motivations may be different for SBOs depending on circumstances, but do they really underperform primaries?

Degeorge: “It depends. SBOs made early in the fund’s investment period look a lot like primary buyouts. The late SBOs are the ones that are potentially problematic; they are an easy way to use capital if a fund is a little late in its schedule to spend the cash. We are looking at a large difference in performance, especially because late SBOs have fewer ‘home runs’. What can account for that? Perhaps these funds invest first in the most valuable target companies, then, as time goes by, they reach companies that are less valuable. Following

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*Lee Gardella,
Adveq*

“THE RELATIVE ATTRACTIVENESS OF A SECONDARY BUYOUT DEPENDS ON A NUMBER OF FACTORS, INCLUDING THE MACRO ENVIRONMENT, SPECIFIC INDUSTRY DYNAMICS AND STAGE OF DEVELOPMENT OF THE BUSINESS”

*Pete Wilson,
3i Group*

that logic, late primaries would also underperform, but they don’t. So, most likely, the real reason late SBOs underperform is that buyers overpaid.”

Wilson: “I would answer that differently. Driving performance is about understanding the business and what you are buying. Two of the key factors are the price you paid on the way in and having the right team in place. Take the case of Zenith, the car-leasing business. We sold it successfully to Dunedin, which then also made money on it when it sold the business to Barclays Private Equity. Barclays sold it to Morgan Stanley Global Private Equity and HgCapital recently bought it.

“Zenith has been passed around because it is a good-quality business where you can add value, and investors have been paying sensible prices. In my mind, driving performance is about understanding what it is that the company does, paying the right price on the way in, knowing where you are going to add value and then actively contributing. You do that irrespective of the structure.”

Lo: “In the past two years, particularly in China, there has been a lot of chatter among the PE community about buyouts. They want to focus more on control deals because of some pretty high-profile accounting fraud cases, particularly among Chinese companies that listed in the US via reverse takeover processes. PE firms want more control over the company operations and their exit.”

So how do secondary and primary buyouts differ in characteristics?

Wilson: “I think it is difficult to generalise the differences between primary buyouts and SBOs. I suppose you could say that most SBOs are sold through an auction process, so you have the competitive process having an impact on pricing and structure to an extent.”

Fluck: “Yes, that is true, but the motivations of auction participants have a bearing on performance and structure. We were surprised by the strength and consistency of our results.

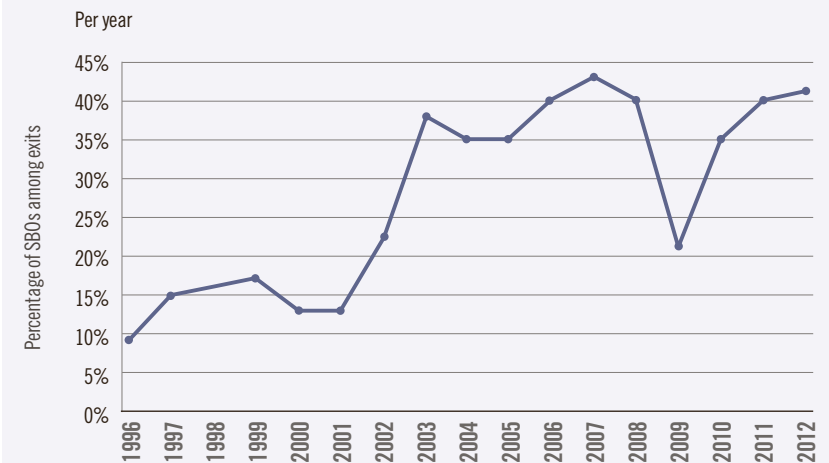
“We found that pressured buyers and pressured sellers pay differently. We document that pressured sellers receive lower transaction multiples than other sellers, and we also report that if the buyer is more pressured, the price is higher. It is the pressure differential that really matters.

If buyers and sellers are equally pressured, price is unaffected. When a more pressured buyer meets a less pressured seller, the buyer pays higher prices; when a less pressured buyer deals with a more pressured seller, the seller is willing to accept lower multiples. When pressured buyers invest in SBOs, they use less leverage and syndicate less: those guys want to spend their equity. Sellers are more pressured when they come close to the tenth year of the fund and haven’t had recent successful exits; if they have to write [an investment] off, the whole IRR of the fund will be significantly affected.”

Degeorge: “You need to distinguish between performance for target companies versus investment performance for LPs; lower target gains for target companies do not necessarily mean lower gains for LPs. It depends on the pricing. It is true that, on average, SBOs generate fewer operating performance gains for the target company. But that alone can’t explain the investment underperformance of SBOs, because SBOs are auctioned, so their pricing should factor in gains in operating performance.”

Given some of the findings, should LPs discourage late SBOs?

INVESTMENTS EXITED VIA SECONDARY BUYOUTS



Source: Degeorge F, et al, Agency costs and investor returns in private equity: Consequences for secondary buyouts, December 2013

Fluck: “If GPs knew that LPs would especially scrutinise investments made under buy pressure, then the GP would look at the trade-off between losing some of the management fee now and compromising its ability to raise new funds successfully in the future. It would think twice about making those investments.”

Degeorge: “This trade-off may already be in place. If you look at a fund that has done a lot of late SBOs, the size of the follow-on fund is quite a lot smaller. All other things being equal, if a fund goes from spending nothing to spending 10% of its capital on late SBOs, the next fund by the same GP is 20% smaller.

“One explanation for this might be that the GP decides that it’s hard to source good opportunities, so they scale back the fund. I am a little bit sceptical of this explanation, but we can’t rule it out. The other is that investors penalise the fund by providing less capital. They may decide that this GP has not been able to source good deals or they could feel that the GP has destroyed value: whether you use other buyouts or public markets as a benchmark, later SBOs underperform.”

Gardella: “As an LP, we wouldn’t discourage them in our market. Our focus is on smaller deals and smaller transaction sizes. We love the SBO activity; we have been the beneficiary of it. It has been a great exit channel for Adveq. If we were looking at a manager backing an SBO, we would look at it just like any investment they make.”

How long can the game of “pass-the-parcel” for SBOs continue?

Degeorge: “The ‘pass-the-parcel’ characterisation of SBOs implies that they are disasters waiting to happen. I think that is unfair. Some SBOs are value-increasing for the target companies. I don’t expect them to end any time soon. Some buyers overpay for SBOs, especially when they invest late in their investment period. That is an issue to which investors should pay attention, and some of them do already.”

Fluck: “There is a backlog of SBOs yet to be exited. A more healthy IPO market will help to exit some of these SBOs. But some will be written off and will not be viable. And it is likely that agency motives will continue to be a significant driver in late SBO deals.”

The research

In their paper *Fund Managers Under Pressure: Rationale and Determinants of Secondary Buyouts*, Sridhar Arcot and José-Miguel Gaspar (both of ESSEC Business School), Zsuzsanna Fluck (Michigan State University) and Ulrich Hege (HEC Paris) investigate whether secondary buyouts (SBOs) maximise value or reflect opportunistic behaviour.

The authors use a sample that includes all completed LBO transactions in the US and 12 European countries from 1980 to 2010, tracking the exit type and date for the 4,139 that have exited, of which 1,219 are SBOs.

To proxy for adverse incentives, they develop buy-and-sell pressure indices based on how close PE funds are to the end of their investment period or lifetime, their unused capital, reputation, deal activity and fundraising frequency. For example, a fund that is reaching the end of its investment period with a large amount of unspent capital and that is managed by a GP without a good reputation or long fundraising history would be classified as being under buy pressure. Funds under sell pressure would be those close to the end of the fund life with few exits, lacking a reputation and long fundraising history. The research finds that funds under pressure engage more in SBOs on both the buy and sell sides.

They also find that in an SBO transaction, pressured buyers pay higher multiples, use less leverage, and syndicate less. The paper suggests that their motive is to spend equity. Pressured sellers are found to exit at lower multiples and have shorter holding periods. When pressured counterparties meet, deal multiples depend on the differential bargaining power. The paper also finds that funds that invested under pressure underperform.

In *Agency costs and investor returns in private equity: Consequences for secondary buyouts*, François Degeorge (University of Lugano), Jens Martin (University of Amsterdam) and Ludovic Phalippou (Saïd Business School) reflect that because PE funds are structured as finite-life entities with a fixed investment period, fund managers with unspent capital towards the end of a fund’s investment period have an incentive to burn capital. The authors believe that SBOs are a natural channel for doing this.

The authors compare 421 exited SBOs with 4,326 exited primary buyouts for deals completed between 1986 and 2007 in North America, Western Europe and Scandinavia. They find that SBOs underperform primaries by around 20%, but that the SBO underperformance is concentrated in those completed late in the fund’s investment period – particularly when the fund has a large proportion of unspent capital at this stage; early SBOs have a similar performance to primaries. Overall, they find that agency problems are responsible for SBO underperformance.

Tim Jenkinson (Saïd Business School) and Miguel Sousa (University of Porto) examine SBOs as the seemingly preferred route for PE investors. They assess why SBOs have gained in popularity relative to IPOs and sales to corporate acquirers. In their paper *Why Do Private Equity Firms Sell to Each Other?* the academics analyse 759 European PE exits completed between 2000 and 2007, using information on PE fund and portfolio-company characteristics and on conditions in capital markets. Of these exits, there are 259 trade sales, 11 public offerings and 345 SBOs.

They find that over 45% of exits in the sample are via SBO, but that market conditions affect choices. IPOs are favoured over SBOs when stock markets rise strongly; SBOs are favoured in times of cheap, abundant leverage, particularly for portfolio companies with a higher capacity to service debt. Trade sales are favoured over SBOs for smaller companies that have experienced strong growth.

However, the research finds that SBOs are, overall, more attractive than IPOs because GPs can achieve a clean exit, and that more experienced GPs tend to sell via SBO to less experienced GPs. The results are also consistent with the two previous studies in that SBOs tend to occur at a later point in the investment period, suggesting that a lack of primary deals may be the motivation for many SBOs.



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