SECOND HAND, SECOND RATE?

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.

Chaired by Lisa Bushrod.

Zsuzsanna Fluck
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Zsuzsanna Fluck is associate professor of finance and director of the Center for Venture Capital, Private Equity, and Entrepreneurial Finance at the Eli Broad College of Business at Michigan State University. Her research expertise is in financial contracting, security design, mergers and acquisitions, corporate restructuring, corporate governance, VC, and PE companies.

Pete Wilson
3i Group
Pete Wilson is a director of PE at 3i Group. His focus is on originating and executing PE investments across Europe. He also leads 3i’s activities in the UK business services sector. Recent deals he has worked on include the sale of Inspectorate to Bureau Veritas, the public-to-private of Inspiro and 3i’s recent exit of Civica.

François Degeorge
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François Degeorge is dean of the Faculty of Economics at the University of Lugano and holds a senior chair at the Swiss Finance Institute. He is also president of the European Finance Association. He has been a visiting professor at the Tuck School of Business (Dartmouth) and at Université Paris-Dauphine. His research interest is in corporate finance and he has won several awards for the papers he has published.

Tim Jenkinson
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The Jenkinson is a professor of Finance and head of the Finance Faculty at Said Business School, University of Oxford. He is also the director of the Oxford Private Equity Institute. His areas of expertise include PE, IPOs, institutional asset management and the cost of capital. He has been published in journals including The Journal of Finance, The Journal of Applied Finance and The Review of Financial Studies.

Lee Gardella
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Lee Gardella is the head of Adveq’s US office and leads the firm’s risk-management efforts. He is also a member of Adveq’s management committee. Before joining Adveq in 2007, he was a managing director leading the Private Markets Group for CIC Consulting, the family office investment advisory subsidiary of US Trust Company in Stamford, Connecticut.

Bonnie Lo
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Bonnie Lo is a founding partner of NewQuest Capital Partners where her role includes co-heading the Greater China business of the firm and overseeing investments in the consumer and healthcare sectors. She has over 13 years’ experience in finance and has been working in principal investing for more than 10 years. Prior to this, she focused on Greater China while working for Bank of America Merrill Lynch’s Asia Private Equity group and also while at 3i Group.

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 for 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: ‘Oh, 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 stop.”

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, realising 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.”

“OUR RESEARCH FOUND THAT PRESSURED BUYERS ARE MORE LIKELY TO DO SECONDARY BUYOUTS, PAY HIGHER MULTIPLES AND USE MORE EQUITY IN THEIR DEALS”

Zsuzsanna Fluck, Michigan State University
**IN A SECONDARY BUYOUT, YOU PAY A HIGH PRICE FOR A WELL-PERFORMING COMPANY. IF IT DOES NOT CONTINUE ON THE SAME TRAJECTORY, THAT COMPANY IS RISKY. IF YOU HAVE PAID A FULL PRICE AND LEVERAGE AS FAR AS YOU CAN**

Lee Gardella, Adviso

### 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


### “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”

Francois 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 market 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. Whether 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 worst. 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 the highest 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.”

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 successully to Dunedin, which then also made money on it when it sold the business to Barclays Private Equity. Barclays sold it to Morgan Stanley with private equity and HgCapital recently bought it.”

Wilson: “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.”

Lee: “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 primary SBOs?

Degeorge: “It depends. SBOs made early in the fund’s investment period took 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 that logic, late primaries would also underperform, but they don’t. So, most likely, the real reason late SBOs underperform is that buyers overpaid.”

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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 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?
The research

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

The authors use a sample that includes all completed SBO 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 unused 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, pressed 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 Phalipaou (Said Business School) reflect that because PE funds are structured as finite-life entities with a fixed investment period, fund managers with unused 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 unused 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 (Said 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 sales 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.