The Rationales Behind Secondary Buyouts
- A study of the Swedish PE market

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Abstract

This paper investigates the motives behind secondary buyouts and analyse if there can still be value creation possibilities when a private sponsor has already been in control. Whereas previous empirical studies have been biased towards primary transactions, this thesis is mainly focused on secondary buyouts. We evaluate six hypothesis related to potential characteristics of secondary buyouts and how they differ from primary transactions. Our results indicate that the proportion of secondary buyouts increase during liquid debt markets and that the buying firm in a secondary transaction in most cases is larger and also more engaged in acquisition activity than the selling. Further, our results suggest that there is a slight difference in focus between primary and secondary transactions, with primaries being somewhat more engaged in operational developments. We also find some evidence of the exit strategies' importance, where secondary transactions to a larger extent are exited in the end of the PE funds' lifetime. Finally, another observed phenomenon is that privately sponsored investments are often sold to another sponsor in association with a new fundraising.

Keywords: Private Equity, Secondary Buyouts, Primary Buyouts

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1. Introduction

The private equity (PE) industry has exploded during the last decade, both with regards to number of deals as well as the size of the transactions (Stromberg 2008a). This relatively new investment type continuously outperforms other ownership structures and delivers exceptional returns to investors (Beroutsos et. al. 2007). Fuelled by the recent success, more and more capital is being allocated into the PE industry and the investments are no longer limited to the small targets but also involve larger investments. With the world's third largest PE investment as a percentage of GDP, outperformed only by US and UK, Sweden has an acknowledged conducive environment for PE investments. In 2006, Swedish PE firms made investments of an aggregated value of SEK46 billion, compared to SEK17 billion in 2004 (SVCA 2007b). Clearly, the PE industry is becoming an increasingly important asset class in the Swedish market.

Being such dynamic market player the industry has attracted more interest but also negative evaluation (Beroutsos et. al. 2007). Critics raise the high valuations made by PE firms as symptoms of an unreliable market. Further concerns are the high PE returns as simply a result of low interest rates and the ability to reach high debt levels rather than operational value creation. Even more questioned are the secondary buyouts, where the owning PE firm sells an investment to another PE firm. The main reason is that critics, such as Flaherty and Davis (2007), argue that if the PE firms are superior, there should not be any significant value creation opportunities for a second PE owner. However, relatively little research has been conducted on secondary transactions as a phenomenon. In light of this issue, our aim is to evaluate if they are different from primary buyouts. If this is the case, there might well be further potential success even after a private sponsor has been in control.

This study therefore intends to investigate the rationales behind the increasing proportion of secondary buyouts in the PE industry and how they differ from primary transactions. Indeed, previous studies within value generation have almost exclusively concentrated on primary transactions; see for example Berg & Gottschalg (2003) for a synopsis of literature on buyout value creation of the last 20 years. However, there does not seem to be any deeper investigation or empirical evidence of how these theories apply to secondary buyouts. Hence, our study is somewhat unique due to its focus on secondary buyouts. The aim is to decompose the rational ground behind secondary buyouts in different characteristics and explanatory factors. Through this process we try to uncover some of the current uncertainty associated with this transaction type and in turn provide more essence to the debate. As far as we are aware, the project is the first of its kind covering secondary buyouts in Sweden, which makes it unique also in an international context. Our data is concentrated to transactions made by the five largest PE houses in Sweden as we feel they provide a realistic and reliable study for the whole Swedish PE market. This leaves us with a total sample of 297 primary and 41 secondary transactions, even though each hypothesis uses varied sub samples. In order to evaluate our hypotheses we combine our quantitative study with qualitative analysis.

We find several reasons why a PE firm sometimes exits an investment prematurely than planned and thus, leaves potential room for further value creation. Firstly, we discover that favourable market conditions have resulted in an increased proportion of secondary buyouts, although it is difficult to separate this effect from the increased acceptance of secondary transactions. Secondly, common characteristics found for secondary buyouts are that the buying funds tend to be larger than the selling funds. This could be slightly connected to our finding that the buying funds generally engage in more acquisition activity. Thirdly, we also find some support for different strategies in primary and secondary transactions. Even though the operational developments seems to be the most important process for both transaction types, the proportion is larger for primary buyouts whereas the PE firms are slightly more engaged in acquisitions and international expansion in their secondary investments. Finally, we find evidence of most exits occurring when the PE firm's are realising their funds or when they are in the process of raising capital for a new fund, a phenomenon that is even more significant for secondary transactions.

The thesis proceeds as follows: the previous research and theoretical frameworks are presented in section two in order to serve as the foundation for our hypotheses, outlined in section three. Thereafter, section four describes our original data set and method including a presentation of the five chosen PE firms. Section five presents the unique method used for each hypothesis as well as the results from our research. This section also includes analysis and deeper reasoning around different explanations for the results, which we have developed during the proceedings with the thesis. Section six presents a regression analysis, where we investigate which one of our hypotheses that has the largest explanatory power. Finally, section seven includes our conclusions as well as suggestions for further research.

2. Previous research and theoretical framework

2.1 The market environment's effect on private equity

Axelson et.al (2008) found that leverage buyout[1] (LBO) transaction activity is positively related to favourable market conditions, defined as low interest rates and high liquidity on the debt market. As an example they use the downturn period in the credit market 2000-2001, when the number of PE-transactions decreased by 25 percent. In addition, Axelson et al (2008) explain that whether deals will be financed depends on the market situation, resulting in over investment in good times and underinvestment in bad times. Furthermore, the possibilities of levering increase when debt is relatively cheap. The same study also found evidence of leverage having a positive effect on the offered price. The first of two suggested explanations to this phenomenon is that when a company expects large future cash flow relative current EBITDA it can uphold more leverage. Growing cash flows, in turn, generate a higher price relative to current EBITDA. The second explanation surrounds the ownership structure. Since the management generally receives a stake in the PE fund they have an incentive to maximise the leverage in every investment as it increases the value of their option. As a result, the price on leverage has a positive impact on boom and bust periods in the PE market.

2.2 Value creation in primary buyout

There are numerous ways in which PE firms can create value in their target companies. Jensen (1989) divides the value creation in buyouts into three different areas: financial engineering, governance engineering and operational engineering.

2.2.1 Financial engineering

PE firms rely heavily on debt financing. On average, about 60 percent of their assets are financed by debt, compared to 40 percent, which is the norm in public companies (Rogers et. al. 2002). Axelson et. al. (2008) found that one reason to the difference in debt levels is that a PE owned company is not as exposed to a high debt to equity ratio as the owner in most cases has the ability to increase equity if necessary. The high leverage has several advantages of which the most important is arguably the tax shield, deducting the company's taxable income (Kaplan 1989). Secondly, increased debt creates large interest payments, which decrease the company's cash flows. This in turn helps to strengthen the managers' incentive to consider cash a scarce resource and allocate capital accordingly (Jensen 1989). Furthermore debt

[1] A buyout which uses leverage in the financial structure is commonly referred to as a LBO (Axelson et. al. 2008)

enhances change by forcing management to rethink their strategy and dispose assets that are more valuable outside the company.

2.2.2 Governance engineering

After a buyout the owners are typically concentrated to one or a few PE sponsors rather than a large consortium of shareholders which makes it easier to align the stakeholders' incentives (Easterwood et. al 1989). This is further improved by the fact that PE firms generally have a pre-set holding period and a clear strategy with their investments, which enhance focus and creates incentives for the management to achieve the target goals (Rogers et. al 2002). The managers' motivations are furthermore increased by high-powered equity incentives. This increases their willingness to optimise profits rather than other unprofitable sources of utility, which is in line with the owners' objectives. Lastly, the buyout sponsors typically maintain a large equity stake, which result in incentives to monitor the board of directors and actively engage in the company's operations (Jensen 1989).

2.2.3 Operational engineering

Muscarella and Vetsuypens (1990) explain that operational engineering is the most important way in which PE firms can create value to their target investments. The two main ways, in which this can be done, is through profitability improvements and growth strategies. Berg and Gottschalg (2003) support this theory by concluding that PE owned companies tend to use resources more effectively. Hence, after a buyout one can often observe profitability improving activities such as cost reductions in the form of reduced capital expenditures, decreased working capital and minimised overhead costs. Furthermore, Jensen (1989) argues that non-core operations tend to be outsourced or divested in order to create a stronger strategic focus. Moreover, a PE owned company is likely to be more successful both regarding organic growth and growth through acquisitions. Firstly, since improved incentives assure that only positive net present value investments are being undertaken (Jensen 1986). Secondly, as the PE firm brings additional capital to the company they expand the possibilities to add-on acquisitions (Axelson et.al. 2008). In most cases this aggressive strategy associated with PE owned companies improves profitability and results in a higher valuation of the company. Thirdly, as PE professionals generally have a broader perspective and more structured focus, they are superior in recognising attractive add-on targets to acquire (Axelson et. al 2007). The larger network and credibility connected to the leading PE houses also enhances access to new markets, suppliers, customers as well as the potential internationalisation process and future financing access (SVCA 2007a).

2.3 The characteristics of a private equity fund

Much research has been devoted to the structure of the PE funds. In order to understand the reasoning behind our hypotheses it is vital to have an understanding of the topic. Axelson et. al. (2007) outline the fund set-up and present a model where the financial structure minimizes agency conflicts between fund managers and investors. A PE firm is represented by general partners (GPs) who tend to be skilled at identifying profitable investments. In order to create an investment fund the PE firm needs investors, Limited Partners (LPs), to contribute the fund capital. Typically, a PE investor is a pension fund, insurance fund, bank endowment, company or an individual. In turn for the financing the LPs receive cash back plus around 80 percent of future profits. The GPs keep all decision rights, the remaining percent of profits and an annual fee of around 2 percent of committed capital paid by the LPs (Stromberg 2008b). Gompers and Lerner (1996) give a description of the covenants restricting the relationship between LPs and GPs. They explain that since the fund has the character of a limited partnership the LPs must have no direct involvement in the activities of the fund (Gompers and Lerner 1996). As a result the forming of covenants and restrictions is a vital but time-consuming process. Sahlman (1990) further explains that it is a necessity in order to assure that the GPs act in the best interest of the LPs and do not participate in non-profit maximizing or high-risk activities. Gompers and Lerner (1996) also explain that the covenants restrict the GPs investment possibilities by prohibiting them from investing more than a certain percentage of capital in a given investment class.

Typically, PE funds start by raising equity at the time when they are formed and thereafter the PE firms raise new funds every two to five years (Gompers and Lerner 1996). Later, when investments are made, additional capital is generally raised in the form of debt (Axelson et. al. 2007). Axelson et. al. (2008) found that a larger fund with more capital has larger value creation opportunities relative a smaller fund, since it is relatively complex for a fund to rise *ex post* capital.

The funds have a pre-set time horizon of usually ten years but with an extending possibility of a few additional years (Gompers and Lerner 1996). The largest part of all investments takes place during the first three to five years of the fund's lifetime. Thereafter, the main focus is to manage the investments and begin to convert them into cash, which is distributed to the parties involved rather than reinvested in new ventures (Sahlman 1990). When the fund is reaching its end, all cash and securities are distributed. However, investments can be divested before the fund reaches its end. Kaplan (1989) found the median time for private ownership of 6.8 years, which lead him to the conclusion that LBOs are “neither short-lived nor permanent”. After this original research the general view of LBOs has been that it is a temporary governance structure, with main purpose to improve inefficient operations and governance in public companies. However, a more recent study made by Stromberg (2008a) comes to the conclusion that the holding period has somewhat increased to around 9 years. The three possible exit strategies for a PE fund are to either sell its holdings through a trade sale, an IPO or through the secondary market (Stromberg 2008b).

2.4 Differences with secondary buyouts

Many of the rationales behind value creation in primary buyouts are eliminated in secondary transactions since there is already a private sponsor in control. The main difference between a primary buyout and a secondary buyout is that in a secondary buyout most of the obvious operational improvements in the target company should logically already have been made. Therefore, one could argue that if there is still value creation possibilities in a secondary buyout, the first PE firm must have slightly failed with their developments. Furthermore, since there is little written about the investment criteria behind secondary buyouts the arguments are not as clear as when it comes to primary investments. The suggested ideas we believe to be of greatest importance for the rationales behind secondary buyouts is presented in the next section and form the basis for our hypotheses.

3. Hypotheses

Based on existing theories and previous research outlined in section two we have formulated six hypotheses about characteristics of and potential rationales behind secondary buyouts, which we aim to investigate further. Certainly, our hypotheses do not capture all bases for value creation and other rationales might have an impact in the decision process. However, we have chosen those hypotheses we believe are of greatest importance. A short description of our hypotheses is outlined in this section.

3.1 The effect of favorable market conditions

As suggested in section two, PE activity seems to be related to beneficial market conditions. Thus, one can suspect that it is going to be harder for the PE firms if the interest rates rise and the debt market turn less liquid. Moreover, the possibilities of value creation through debt arbitrages will be more difficult to capture if the market is entering a recession and the price of debt increases. A recent report by Bain & Company (2006) strengthens this idea by arguing that tougher market conditions would require a new approach from the PE firms. Consequently, one potential result of changed market conditions could be that the private sponsors need to focus more on operational improvements rather than financial engineering. Moreover, since previous research about the relationship between the level of PE activity and liquid debt markets do not consider secondary buyouts we have chosen to evaluate the phenomenon in our sample and compare the proportion of secondary transactions in relation to primary buyouts during boom and bust periods. We expect an increased proportion of secondary transactions during boom periods. The reason behind this is since rising markets are associated with financial arbitrage, which result in that targets are being sold earlier than operationally optimal, leaving room for further value creation by an additional PE owner.

Hypothesis one: *The proportion of secondary buyouts is positively related to favourable market conditions*

3.2 The importance of the buying fund's size

In line with the different ways in which PE firms create value in their investments, presented in the previous research section, is the question about fund size. Investment possibilities are somewhat restricted and additional capital can be difficult to raise *ex post* the original fundraising. Therefore, one potential rational behind secondary buyouts could logically be that the buying fund is larger than the selling fund. Therefore, the latter fund can operate in improvements exterior to the scope of the selling fund's potential. With the aim of investigating whether the difference in fund sizes can be considered a rationale for a secondary transaction we decided to evaluate the size of the two vendors in secondary buyouts, expecting to observe that the buying funds are larger.

Hypothesis two: *The buying PE firm has a larger fund than the selling fund*

3.3 The level of M&A activities

One possible restructuring that requires large capital investments is mergers and additional acquisitions (M&A). In order to evaluate whether this has any explanatory power behind the potentially larger size of the second fund we decided to investigate the level of M&A activity before and after secondary buyouts and compare the results with primary buyouts. A relatively large supply of capital could result in extended opportunities to engage in merger and acquisitions, which many PE firms consider as one of their main competitive advantages. This is emphasised in a recent Booz Allen Hamilton report (2007) comparing PE firms with public companies. The report argues that the most successful investors continuingly analyse their portfolios and follow reviews with action, including divestitures as well as acquisitions. Hence, we expect increased M&A activity for the target firm to follow secondary buyouts.

Hypothesis three: *The buying funds in secondary buyouts are more engaged in M&A activity than the selling*

3.4 The buying fund is bringing new expertise to the target company

Another suggested theory in favour of secondary buyouts is that the buying firm might bring new expertise to the acquired company. There are many industries in which the private sponsors do not want to invest, since they do not consider themselves being competent enough within all industries (Urwitz 2007). Perhaps the first PE firm was superior within a certain area while the new investor has other comparative advantages, which increases the likelihood of improvements. If the selling PE firm, as an example, has an operational focus and is satisfied with their operational restructurings the investment might still be interesting for another PE firm with international expansion as their competitive advantage. Consequently, we believe that we will be able to observe different focus areas for primary and secondary transactions.

Hypothesis four: *Secondary investments have different focus from primaries*

3.5 The fund is closing down as a reason for exit

As described in section two, all PE funds are restricted by a pre-set time horizon. However, in some cases the value creation process takes longer than the time horizon allows. The restrictions in extending the fund's lifetime could also result in that in certain cases it is better to sell the company to another PE firm. The main reason to this is that a newer fund with a longer time horizon increases the opportunities to further develop the company and benefit from the improved value. Hence, according to this hypothesis there might still be potential gains in a secondary buyout due to the pre-set time horizon of the fund. Consequently, we expect a high proportion of the secondary buyouts to be exited in connection with the realisation of the selling fund, since that implies further value creation possibilities for an additional fund.

Hypothesis five: *The investment is exited since the selling PE owner's fund is reaching the end of its life*

3.6 The selling private equity firm is issuing a new fund

Another possible explanation behind why some target companies are sold at a relatively early stage could be that the investing PE fund is in the course of a new fundraising. One can argue that when PE firms are searching for new investors they want to confirm earlier "tombstones" with the aim of proving their expertise. Consequently, in order to show the potential new investors how good their previous funds or specific investments performed they might sell some of their most successful investments. Therefore, investments are occasionally exited even though the initial strategy is not completed and the first owner could have captured further gains. To the outsider this would appear to be a successful exit and therefore adds value to the firm's reputation. As a result, the benefits that come with selling the company might overweight the downside. In line with this theory, our last hypothesis is that we will be able to observe an increased number of secondary exists when the owning PE firm is raising capital for a new fund.

Hypothesis six: *The investment is exited since the first PE owner is raising capital for a new fund*

4. Methodology

In order to evaluate our hypotheses we have performed both a quantitative and a qualitative study. Our qualitative study consists of interviews with PE practitioners. We found a complementary qualitative study motivated, since our statistical testing in many cases is based on a limited number of transactions. This section outlines a description of the investigated PE firms as well as the data collection process. The unique method used for each hypothesis will be presented in section five.

4.1 Presentation of the evaluated private equity firms

In order to specify our data sample we decided to investigate five of the leading Swedish PE firms operating in the Swedish as well as global market. We chose to limit the sample to these firms not only to simplify our testing but also since previous research suggests that it is only the best PE firms that actually improve their target companies. A recent McKinsey research by Beroutsos et. al. (2007) show that 75 percent of the PE firms do not create value while the top 25 percent outperform the stock market indexes, both consistently and with a considerable margin. Since we have focused on rationales behind secondary buyouts assuming that they create value we found the largest firms most representative of the whole market. A description of our investigated PE firms is presented in table 4.1.1 below.

Table 4.1.1 Summary of the investigated private equity houses[2]

Company	Altor	EQT	Industri Kapital	Nordic Capital	Procuritas
Founded	2003	1995	1989	1989	1986
Number of funds (closed and current)	2	11	6	6	3
Invested Capital	1,8 bn Euros	11 bn Euros	5,7 bn Euros	4,7 bn Euros	0,32 bn Euros
Average fund size	0,9 bn Euros	1 bn Euros	0,95 bn Euros	0,78 bn Euros	0,11 bn Euros
Investment Characteristics	Mid-sized companies	Mid-sized companies that are high quality market leaders	Mid-sized companies with a strong market position but not yet market leaders	Mid-sized companies	Mid-sized companies with a strong product or market position
Focus Areas	Operational improvements, business development and strategic repositioning	Industrial acceleration	Profit improvement, sustainable growth, international expansion and strategy	Management buyouts, acquisitions, restructurings, strategic repositioning and international expansion	Management buyouts and buy-in transactions
Region	Nordic region	Northern Europe and Greater China	Sweden, Finland, Norway, Denmark, the Benelux countries, France and Germany	Mainly Nordic Region and Europe	Nordic region
Industries	All industries	Growing industries	Mature Industries	All industries	All industries

4.2 Data collection

PE firms consider information about their investments sensitive and therefore normally keep their research and data confidential. For this reason the evaluation of the chosen hypotheses required information and data that is not publicly accessible. Throughout the course of this thesis we overcame this problem by using the Capital IQ database as well as by working closely with the investigated PE firms. Four out of our five chosen PE firms cooperated with us and were willing to participate in interviews. However, the reason why we did not perform a thorough interview with one of the sample houses was because they had never acquired an investment through a secondary, but only participated as the seller. Therefore they did not feel they had the appropriate experience to contribute within this topic. In order to avoid positive bias in our analysis we also completed an interview with one manager from McKinsey, as an independent representative. For a summary of our interviews please consider appendix A.

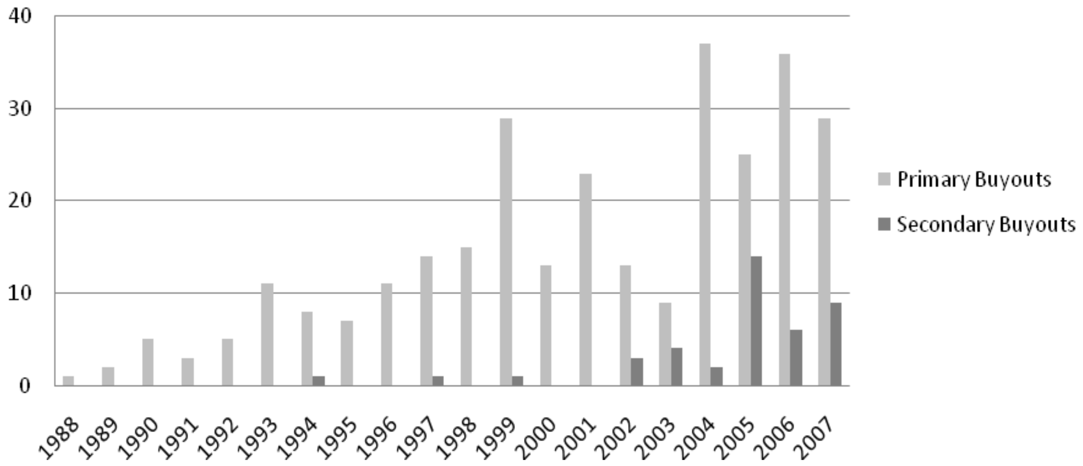
4.3 Descriptive statistics of our data set

Our sample consists of all primary as well as secondary buyouts where one of the top-five Swedish PE firms has been involved either on the sell or buy side. An additional criterion was

[2] All information has been obtained from each PE firm's company website (2007-11-20). www.eqt.se, www.altor.se, www.industrikapital.com, www.procuritas.se, www.nordiccapital.se.

that all necessary transaction data was possible to obtain, which was not possible in all cases due to the confidentiality described previously. We have not limited the time horizon, which results in a time period between 1988 and 2007, although the majority of the transactions (82 percent) occur during the last 10 years. This gives us a sample of 338 transactions in total, divided between 297 primary and 41 secondary transactions. Table 4.3.1 summarises the historic distribution of the investigated transactions. The table shows that the PE activity has grown rapidly during the last 20 years, even though the growth is somewhat uneven. What is even more interesting to observe is that the secondary transactions' proportion of the total PE market has increased significantly during our sample period.

Table 4.3.1 Historic distribution of sample transactions



In some cases the PE firm in question is one part of a larger consortium, which makes it difficult to define the exact role of our PE firm of interest. However, since this is a common feature in the PE market and we wanted to keep the sample of a sufficient size we also include those transactions. A summary of the descriptive statistics is presented in table 4.3.2 below. Worth noticing is that there is large difference between the smallest and largest funds, which could be a further indication of the overall growth in the PE industry during our evaluated period.

Table 4.3.2 Summary of descriptive statistics

Descriptive statistics	
Total no of transactions	338
Primary transactions	297
Secondary transactions	41
No of sample PE firms	5
No of sample funds	28
No of realised funds	12
Largest sample fund size	EUR4.25 bn
Smallest sample fund size	EUR28 mn
Average fund size	EUR1.2 bn

Since we use different approaches for evaluating the hypotheses we apply varied transaction characteristics for each hypothesis. Therefore each hypothesis requires a unique sub sample. Table 4.3.3 summarizes the number of transactions we use in each hypothesis. A more detailed description of the different methods and sub samples is presented in section five.

Table 4.3.3 Total number of transactions used for each hypothesis

Data sample for each hypothesis (H)	H 1	H 2	H 3	H 4	H 5	H 6
Total number of transactions	209	36	76	51	97	110
Secondary transactions	38	36	41	23	12	25
Primary transactions	171	0	35	28	85	85

5. Results and analysis

In this section we present the results from our quantitative as well as qualitative study. For each hypothesis we firstly summarise the outcome of our conducted interviews. Thereafter, we present the quantitative results; including the method used for each hypothesis as well as the test results.

5.1 Hypothesis One: *The proportion of secondary buyouts is positively related to favourable market conditions*

5.1.1 Interview results

Our interviews clarify that the interest levels do not have any direct impact on the buyout activity but rather market circumstances associated with it, such as market growth and profitability possibilities. This is explained by the fact that an investment with high growth and profitability can handle higher interest costs, but it is when the profitability and growth is decreased the PE houses face real problems. Hence, due to the current market instability the PE houses are more concerned about cyclical companies with high correlation to the market.

Two of our interviewees believe that during liquid market periods the PE firms tend to exit their investments prematurely than originally planned, due to expected value decrease in the future. Therefore, a recession is expected to increase the average holding period of investments, since they will be held according to the initial strategy. This is likely to affect the proportion of secondary exits to a larger extent. The main reason is since many secondary targets are not a natural part of a broader industry, which makes it more difficult to find buyers. Furthermore, another interview suggests that as the overall PE activity increases, profitable primary investments become harder to recognize and thus it is natural that the amount of secondary investments increases. Hence, the interviews imply that secondary transactions are more affected by favourable market conditions than primary investments.

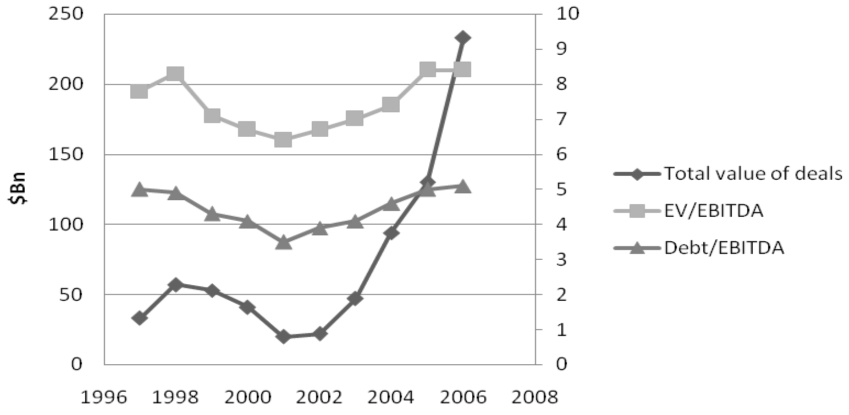
Moreover, tougher market conditions are likely to result in that projects involving less risk will be considered more attractive. The interviews are somewhat contradictory regarding the level of risk in secondary transactions. One interviewee argues that there are more obvious improvement possibilities in a primary buyout and that they are therefore less risky. On the other hand, another interview believes that a company owned by a PE house tends to be easier to evaluate due to well-structured and informative reports, which makes them less risky. Another factor suggesting that secondary buyouts should realistically involve less negative surprises is that the seller is a well-established market player. This result in more incentives to provide truthful information compared to a seller in a primary transaction. Our interviews further explain that whenever a PE firm sells a company they always clarify their future plans and elucidate the potential of the firm to the new owners. The safer nature of secondary transactions is further confirmed by some of our interviewed firms arguing that their ROE is lower for secondary transactions. Therefore secondary transactions are being sold to higher multiples due to the lower risk involved when the selling part is represented by another PE house.

5.1.2 Quantitative tests: methodology and results

In order to evaluate whether secondary buyouts are affected by favourable market conditions to a larger extent than primary buyouts we grouped the transactions by the years they were exited. Since we are interested in exploring the secondary buyouts proportion of the total buyout market, rather than the total PE activity, we aim to investigate whether the proportion of secondary buyouts differ in boom and bust periods. The definitions for the bust and boom periods are based on a recent study by Axelson et.al (2008). The years 2001-mid 2003 are characterised by low equity values, debt levels and LBO deal transactions and therefore considered the bust period. On the contrary, the boom period is defined from mid 2003 until 2006 when increased deal values as well as high debt and equity multiples can be observed. The market development during these periods can be seen in figure 5.1.2.1 below. Even though the figures are based on US data we find it motivated to use the same periods in our sample, since the Swedish market has followed the same development. For example the Swedish interest rate during the bust period was on average 3.8[3] percent whereas the same interest rate was 2.4 percent during the boom period (Swedish Riksbank Internetsource 2007), which we consider significantly lower. We have also extended the boom period to include 2007 since it follows our definition of a boom period and permit a larger sample.

[3] The average interest rates are obtained from the Swedish Riksbank and are based on historic repo rates.

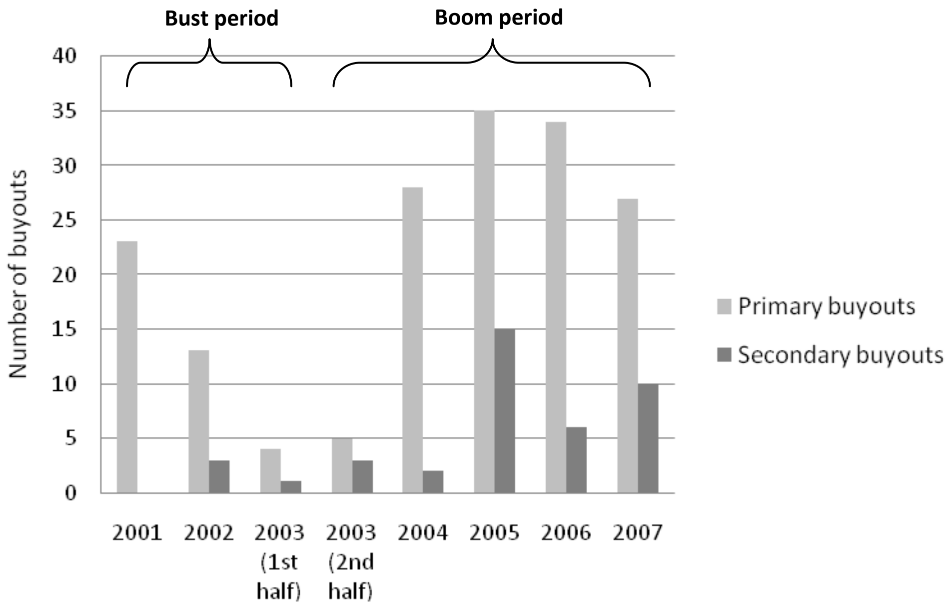
Figure 5.1.2.1 Market trends in private equity buyouts



Source: Axelson et. al. 2008

The majority of our investigated secondary buyouts, 33 out of 38 transactions, are closed during the recent boom period between mid 2003 and 2007. By looking at figure 5.1.2.2 we can conclude that also the primary transactions are concentrated during the last four years. Consequently, when comparing the overall PE activity, we find that it is highly related to the market environment.

Figure 5.1.2.2 Distribution of primary and secondary transactions during boom and bust periods



In order to verify the significance of our indications we performed an independent sample *t*-test. The results presented in table 5.1.2.3, show that the proportion of secondary buyouts increases from 11.1 percent during the bust period to 20.1 percent in the boom period. This implies that secondary buyouts tend to be more affected by market conditions than primary buyouts. Hence, even though the test is insignificant the result indicates what we originally expected.

Table 5.1.2.3 The proportion of secondary transactions in bust and boom periods

	No of transactions	Prop Secondary	Bust-Boom
Bust	45	0,1111	
Boom	164	0,2012	
Mean Diff			-0,0901
T-stat			-1,3880
Sign			0,1670

5.1.3 Conclusion

Our quantitative results show that the proportion of secondary transactions of the total buyout market increases during the investigated boom period. Thus, even though statistically insignificant the result indicates that secondary buyouts are affected by favourable market conditions to a larger extent than primary buyouts. However, the increased proportion of secondary transactions might not only be an effect of the arbitrage possibilities. Another explanatory factor could be that the increased proportion is simply a result of secondary investments being a more accepted asset class today in relation to the previous bust period investigated. Consequently, which of the two factors that have the largest explanatory power cannot be verified until the market has experienced another bust period. One could also argue that the proportion of secondary buyouts in a recession is dependent on whether or not they are considered riskier than primary buyouts, since investors generally become more risk averse during tougher market conditions. Our interviews are somewhat contradictory on this topic, even though the majority believes that secondary transactions involve less risk.

5.2 Hypothesis two: *The buying PE firm has a larger fund than the selling fund*

5.2.1 Interview results

Our interviews concur that the buying fund is larger than the selling in almost all cases. However, they do not fully explain the reason behind this phenomenon. One suggested justification is that the increased capital associated with a larger fund result in expansion possibilities beyond the scope of the previous fund's abilities. One can therefore argue that one possible reason to the buying fund being larger is that the latter fund engages in more capital intense projects. Hence, the previous fund might not have been able to do all possible improvements due to scarce resources. In many cases a fund has to sell an investment with large expansion possibilities due to the fact that the expansion would require additional capital, which could result in the fund becoming too concentrated on one specific investment. In terms of risk, a larger fund can better manage a large investment since the investment will have a relatively smaller proportion of the total fund and thus decrease the risk. Moreover, due to improvements made by the previous owner in a secondary transaction the price paid by the buying fund will be substantially higher than the initial price paid by the seller. Consequently, this implies further requirement for the buying fund to be larger.

5.2.2 Quantitative tests: methodology and results

In order to assess whether the buying PE fund is larger than the selling we compare the relative sizes between the buying and selling funds for each secondary transaction in our sample. Since we found that the differences between the sizes of the two funds were dependent on the equity houses rather than the actual fund sizes we base our size estimates on the current (2007) size of the private sponsors. As an example we assume that Blackstone's funds are larger than most other PE houses, independent on if the transaction was closed 2007 or five years ago. Five of our transactions were excluded due to difficulties to classify the funds' sizes. For a deeper investigation and verification of the significance of our results we also perform a one-sample *t*-test, where we compare the observed mean with the test value *0.5*. All transactions where the buying fund is larger are defined as *1* whereas *0* represent the cases where the buying fund is smaller. If the fund size does not matter we expect a mean of around *0.5* since that indicate that the probability that the second fund is larger than the first is equal to the opposite being true, that the selling fund is larger than the buying. By using the test value *0.5* we aim to clarify if our observed mean is significantly different from the test value.

Our data set shows that out of the 36 investigated observations the buying fund is larger than the selling for 29 transactions and the second fund is smaller than the selling in 7 cases. Thereby, we can conclude that the buying fund is larger for 80.6 percent of our observed transactions. Hence, our descriptive statistics imply that our hypothesis appear true. In order to verify the indications we perform a one-sample *t*-test. The test results are presented in table 5.2.2.1. The results show that the buying fund is notably larger than the selling on a 0.001 significance level. Therefore, we can conclude that the statistical test strengthens our hypothesis and is in line with the ideas brought up during the interviews.

Table 5.2.2.1 The selling and buying fund's size in secondary buyouts

Mean	Mean Diff	T-stat	Sign
0,8056	0,3056	4,5680	0,0000

5.2.3 Conclusion

Both the interviews and quantitative findings support our hypothesis that the buying fund in a secondary buyout is larger than the vendor's fund. The main explanation suggested by our interviews is the expanded possibilities associated with larger funds, but also that the increased value generated by the previous owner demands a higher price. Thus it is natural that the acquiring fund is larger. In addition, a large investment in a big fund does not create as high-risk exposure towards that specific investment relative a smaller fund.

On the other hand, one could argue that the fact that the buying fund is larger than the selling does not imply much about the actual fund size but is rather an effect of the increasing average fund sizes in the market. When looking at our sample PE houses the funds raised around then years ago were considerably smaller compared to the funds raised more recently[4], as a result of the increased market liquidity. Hence, since the buying fund acquires the target company later and assuming that the buying fund is newer than the selling the difference in size can partly be explained by the average increase in fund sizes during recent years. However, when performing our fund size separation we considered this phenomenon. Hence, since the fund sizes were determined based on the PE houses rather than individual funds we are confident that our results are valid.

5.3 Hypothesis three: *The buying funds in secondary buyouts are more engaged in M&A activity than the selling funds*

5.3.1 Interview results

Our interviews explain that unconsolidated industries result in a potential for the PE firms to invest and merge companies in order to create scale advantages. On the other hand the interviews proved somewhat contradictory regarding the level of M&A activity after primary and secondary transactions. Two of the interviewed representatives argue that the buying funds could be a more active acquirer since they are generally larger with greater expansion

[4] The average size of funds raised around ten years ago by our sample PE houses comprised committed capital of approximately EUR467 mn compared to the latest funds, which average EUR1845 mn. The figures are obtained from the PE houses company web sites (2007-11-20). www.eqt.se, www.altor.se, www.industrikapital.com, www.procuritas.se, www.nordiccapital.se.

possibilities. They further explain that the first fund in many cases needs to focus on internal operational restructurings and developments, which takes focus from further add-ons. Hence, in many cases the invested firm does not live up to the standard required for further acquisitions. In contrast, two of our conducted interviews believe that the level of M&A activity is similar for primary and secondary transaction even though they explain that the type of acquisitions might vary. Primaries often focus on merging two or more companies whereas secondary transactions often involve add-ons and international expansion acquisitions.

5.3.2 Quantitative tests: methodology and results

A reasonable way to evaluate whether the second fund is more engaged in M&A activities, defined as number of acquisitions, is by studying the acquisition activity after secondary buyouts in relation to primary transactions. However, one problem with this method is that if considering the entire holding period very few of our observations are closed transactions. This results in that the level of M&A activity for the buying funds might be undervalued for the transactions with remaining holding time. In order to overcome this difficulty the level of acquisition activity is also evaluated at different time periods after the transactions. The number of acquisitions one, two, three and four years after the secondary transactions is compared with the same development after primary transactions. The question to be answered in this situation is if the focus on M&A activities is unique for secondary buyouts or similar for primary transactions. In order to get a testable sample of primary transactions we randomly selected 35 out of the 297 transactions involving one of our sample firms on the buy side.

By studying our closed transactions we can conclude that the buying fund operates in a higher level of M&A activity for 4 out of 15 closed transactions whereas the selling fund engage in more M&A activity in 3 transactions. Since there are no large differences this does not strengthen our hypothesis about increased M&A activity. In order to test for potential differences at other times we perform paired sample *t*-tests for the five evaluated time periods. The results from the tests are shown in table 5.3.2.1. The table shows that secondary buyouts are more engaged in M&A activity for all evaluated time periods. Consequently, we can conclude that even if the tests are insignificant the number of acquisitions made by the different PE owners indicate that secondary targets engages in M&A activities to a larger extent than primaries.

Table 5.3.2.1 Number of acquisitions made by the target in primary and secondary buyouts at different times

Years	Mean Primary	Mean Secondary	Diff Sec-Prim	T-stat	Sign
0-1	0,3824	0,4706	0,0882	0,321	0,750
0-2	0,7353	1,2059	0,4706	1,125	0,269
0-3	1,1176	1,2941	0,1765	0,394	0,696
0-4	1,2353	1,2941	0,0588	0,131	0,896
0-Closed	0,8000	1,5333	0,7333	1,361	0,195

5.3.3 Conclusion

Although our results are insignificant, we find a weak tendency towards more M&A activity in secondary buyouts. This can be partly explained by the generally larger size of the buyers, which give them more opportunities to engage in capital-intensive acquisition activities. In contrast, our interview results are contradictory regarding the level of M&A activity for secondary buyouts in comparison with primaries. The main reason against increased number of acquisitions for secondary transactions is that acquisitions are one of the PE firms main focus areas. Hence, they engage in M&As for both their primary and secondary investments.

5.4 Hypothesis four: *Secondary investments have different focus from primaries*

5.4.1 Interview results

Some of the interviews argued that primary and secondary buyouts in many cases are dissimilar investments with different requirements from the PE firm. In a primary deal the main focus tend to be large restructurings and internal developments whereas secondary buyouts engage more fine changes and often involve expansion. Therefore, it seems reasonable to assume that the PE house will have different focus depending on if they are acquiring a primary or a secondary target. Hence, the dissimilarity between the two transaction types could be a potential rationale behind secondary buyouts.

In addition, our interviews emphasise that the PE firms' strategies with their investments are rather dependent on the target firm's different development stages than diverse focus between the private sponsors. In addition, one interview suggests that the PE sponsors benefit from previous experiences and increased seniority, which result in larger confidence when evaluating potential targets. Another interviewee explain that the most experienced houses with best reputation do not want to get involved at a too early stage, but enter the target company where more complex improvements can be made. On the other hand, other interviews argue that the seniority of the buying and selling funds does not have any significant impact. Consequently, we can conclude that our interviews are contradictory regarding the importance of the buying fund's increased seniority.

Moreover, none of the main Swedish PE houses have specialised niches, mainly since that would minimise the number of available transactions. One of the interviewees explains that this makes the Swedish PE market somewhat different from the US where the large firms are specialised to a larger extent. The same interviewee believes that the PE firms could be even more efficient in their development processes if they were industry specialists for their investments. Hence, even though the interviewed firms were slightly contradicting on this topic we could probably expect more specialised firms in the future in order to keep up with the global development.

5.4.2 Quantitative tests: methodology and results

To investigate if the buying and selling funds' different focuses is a significant rationale behind secondary buyouts our first step was to verify the strategy behind each secondary transaction. In order to do this we used press releases, Factiva News as well as information from the PE firms' websites. For the secondary buyouts in our sample we managed to find information about the acquisition goal for 23 out of the 41 transactions and in order to compare with primary transactions we verified the key strategy for 28 out of 35 randomly selected transactions from our sample. Thereafter the different transaction goals were divided into three main reasons behind why the second fund acquired the target company from another PE firm. The categories were based on the most common reasons brought up as the purposes behind the investments rather than the three different grounds for value creation presented in section 2.2. The main rationales founded were the following:

- *Further operational development of the target company:* The broadest category since it includes many types of improvements within the operational field. However, the majority of press releases mentioned organic growth, new management or other internal improvements such as developments in distributions and product range.
- *Engagement in an active acquisition strategy:* Includes all transactions where an aggressive acquisition strategy seemed to be a key purpose behind the transaction.
- *Focus on international expansion:* Covers all transactions where one of the buying PE firm's main intentions with the acquisition was to expand the target firm into new global markets

The findings from our initial research and tests are presented in table 5.4.2.1 and 5.4.2.2. Out of the 23 evaluated secondary transactions 69.6 percent mentioned further development as a rationale behind the transaction whereas the same figure for acquisition and international expansion was 52.2 and 34.8 percent respectively. For primary transactions, the proportions were 82.1, 35.7 and 21.4 percent. Hence, our sample indicate that further operational development in various forms tend to be the greatest underlying principle behind primary as well as secondary buyouts even though the figure was significantly higher for primary transactions. Although it is important not to forget that the wider scope of this rationale could be an explanation to why it seems to be the most common reason, the result strengthens the argument that there are still outstanding operational improvements for latter PE firms. In order to verify the validity of our findings we also perform an independent sample *t*-test. The results from the tests are presented in table 5.4.2.2. Even though insignificant, our tests indicate that primary transactions are focused on operational developments to a larger extent whereas secondary transactions are slightly more involved in acquisitions and international expansion.

Table 5.4.2.1 Distribution of secondary and primary transaction over the varied focus areas

	No of Trans.	Development	M&A	International exp.
Primary	28	0,8214	0,3571	0,2143
Secondary	23	0,6957	0,5217	0,3478

Table 5.4.2.2 Comparison of the difference in focus between primary and secondary transactions

	Mean diff Sec-Prim	T-stat	Sign
Development	0,1258	1,044	0,3020
M&A	-0,1646	-1,174	0,2460
International exp.	-0,1335	-1,054	0,2970

5.4.3 Conclusion

We have found that our sample PE houses are not specialised towards certain focus areas but the press releases as well as the interviews indicate that it is rather the current phase of the investment that determines both the ownership structure and what sort of value generating activities the PE firm will focus on. Even though insignificant our tests indicate that secondary transactions are more focused on acquisitions and international expansion whereas primary transactions are involved in operational development to a larger extent.

5.5 Hypothesis five: *The investment is exited since the selling PE owner's fund is reaching the end of its life*

5.5.1 Interview results

Since secondary buyouts imply further value creation potential under a second PE owner one could question why the first owner do not maintain the investment. The explanation comes down to a few important reasons. According to the interviews the most obvious is that the selling PE firm's fund is running towards the end of its life and do not have time for further improvements. A PE firm is hesitant to ask its investors to prolong the lifetime of the fund since it could be a negative signal towards future investors not to keep the pre-set time horizon. One could argue that it would be better to keep the company and move it into another fund but that is a practically difficult process since it creates a conflicting situation for the PE firm representing both the buying and the selling side.

Since our interviews confirm that one of the main reasons to exiting an investment is that the fund is reaching its end, the largest part of all exits should naturally occur in the end of the fund's lifetime. However, as previously discussed, beneficial market conditions could also have an impact on early exits. This is twofold; firstly since beneficial market conditions can speed up improvements and secondly since the large market liquidity can have a positive impact on price offered for a company. Thus, it might be beneficial for a PE firm to exit a company even though they have not yet completed their initial strategy.

In contrast, a justification for exiting primary investments earlier than secondary investments could be that there are fewer goals with primary targets, resulting in shorter holding periods. One interview suggests that in a secondary investment the initial PE owner has already carried through the most obvious improvements. Therefore, the following PE firm has to engage in more complex and time-consuming improvements which in turn increases the risk of not having enough time for completion. On the contrary, primary targets are generally relatively poorly managed and often lack clear and structured reporting systems. Such issues take long time to implement and thus, can result in longer holding periods than secondary buyouts.

5.5.2 Quantitative tests: methodology and results

When examining this hypothesis we include all transactions made in realised funds where our sample PE firms have been involved on the sell side. We chose not to include funds that are not yet realised since that could create a bias towards early exits. The lifetimes of the funds are divided into the “early” and “late” periods. The early period is defined as the first half of the funds lifetime whereas all exits made in the second half is included in the late period. The purpose with this split is to simplify the comparison between the two periods. In order to find support for our hypothesis we expect to find a larger proportion of secondary buyouts compared to primary buyouts in the later half of the funds’ lifetimes since that could be a sign of timing as the reason for selling. Hence, indicating that there was still potential value creation in the target companies.

During our investigation we recognized two distinct problems: verifying the lifetimes of the funds and identifying the funds on the sell side. In those cases where information was not given a lifetime of ten years was assumed since that can be considered the average lifetime of a fund (Gompers and Lerner 1996). Secondly, for some transactions the limited information made it impossible to accurately identify the selling fund. In those cases the transactions have been excluded from the data. However, due to the small number of unallocated transactions we believe this effect to be minor on the overall result. Since the transactions are not evenly distributed between the different funds, i.e. larger funds have generally been involved in more transactions, we perform two different tests. Firstly, we tested the proportions of secondary buyouts on a fund level with the purpose of preventing bias towards the larger funds. However, this leaves us with a rather limited sample of 12 realised funds. Therefore we also perform a test based on the total number of transactions creating a larger sample. The transactions are classified as “early” or “late”.

The results show that out of the 12 investigated funds, 68.0 percent of all exits, occur in the second half of the funds’ lifetimes, leaving 32.0 percent of all exits to the early period. This is in line with our expectations that most exits occur late. 91.7 percent of all secondary buyouts occur in the late period whereas the same number for primary buyouts is 64.7 percent.

Table 5.5.2.1 Summary of transaction distribution

	Exits H1	Exits H2	Total	Prop. of exits H1	Prop. of exits H2
Primary exits	30	55	85	0,353	0,647
Sec exits	1	11	12	0,083	0,917
Total	31	66	97	0,320	0,680

In order to verify the significance of our results we perform an independent-sample *t*-test. The results from the test are presented in table 5.5.2.2. The test is significant at a 10 percent level, which indicates an increased proportion of secondary buyouts in the latter part. Hence, the test is in line with our expectations.

Table 5.5.2.2 Buyouts exited in the second half of the funds' lifetime

Funds	Prop of exits H2, %	
Primary exits	0,647	
Sec exits	0,917	
Mean Diff		-0,270
T-stat		-1,890
Sign		-0,062

5.5.3 Conclusion

Based on our results we can conclude that there seem to be a trend in accordance with our expectations that most secondary buyouts occur late in a fund's lifetime. The explanation of greatest importance is that most investments are supposed to be held for a certain number of years, which naturally puts them in the late half of a funds life. However, the proportion for secondary buyouts is larger than for primary investments. One possible explanation to this phenomenon could be that the secondary targets often involve complicated and therefore more time consuming restructurings which results in that their initial strategy is not completed when the fund is closing down. The interview results include arguments both in favour and against that being the case. Furthermore, due to the limited possibilities in extending the funds' lifetimes as well as the difficulties to move an investment to a younger fund, a PE firm is likely to exit its investments even though there are further gains to be captured.

5.6 Hypothesis six: *The investment is exited since the first PE owner is raising capital for a new fund*

5.6.1 Interview results

Although contradictory on this topic, one interview confirms that when a PE firm is raising a new fund they want to prove their success. Therefore it might be beneficial to exit investments with exceptionally high returns. For example, an investment that has earned the fund an IRR of 100 percent can continue to be profitable to a lower return. Thus, in times of a new fundraising it might be more beneficial for the PE firm to show investors an annual return of 100 percent than an annual return of 80 percent. As a result, they exit the company prematurely than originally planned on behalf of investments in the new fund.

Our interviews also explain another phenomenon in line with this hypothesis. Potential new investors of a fund sometimes do not want the PE firm to have too many portfolio companies to focus on, since that draws attention from their fund. Hence, in order for the PE firm to put enough resources into managing new investments they have to limit the number of holding companies and exit some older investments. As a result, the PE firm sometimes exit investments, with additional profits possibilities, in order to keep potential investors for the new fundraising interested. Thus, that leaves room for further value creation under a second PE firm's control. Our interviews however, also explain that there are some restrictions. Firstly, it is not possible to exit an investment unless it is economically defensible since investors of the first fund would be disadvantaged. Secondly, focusing on just a small number of investments increases the risk and therefore a too limited number of investments are not optimal. However, this effect is offset if the fund's remaining investments have a satisfactory level of diversification. In addition, if the exited investments have earned the fund the required return that in turns secures some of the fund's expected profit at an early stage.

Another potential reason to a larger proportion of secondary exits in association with new fundraisings could be related to liquidity and the fact that PE firms usually want to continue satisfactory investor relations. Investors of an older fund might demand their former investments to be divested, as a requirement for reinvesting in a new fund. This could explain the high proportion of exits around the time of a new fundraising. Another reason why PE firms generally prefer long relationships with investors is if they are not able to realize the promised returns. In that case an old investor is more likely to be relatively more forgiving if they have made large profits on previous investments.

5.6.2 Quantitative tests: methodology and results

When investigating whether there is any relation between secondary buyouts and new fundraisings we selected the transactions where our sample PE firms acted as sellers. Thereafter we divided the transactions between primary and secondary exits, depending on if the buyer was a PE firm or an industrial actor. Transactions that occurred six months before an announcement of a new fundraising until the closing date of that fundraising are considered to be related to that fundraising. We expect the proportion of secondary buyouts to be larger close to, or during, a new fundraising. All transactions exited close to a new fundraising are defined as *1* and all other transactions are defined as *0*. For some funds we were not able to assess the date when the fundraising was closed. For these cases we assume that the fund closes six months after its announcement since this is considered to be a reasonable time span for a new fundraising (Stromberg 2007). However, we do not find this assumption to have any impact on our results.

Out of the 85 investigated primary transactions, 33 (38.8 percent) were exited close to a new fundraising, compared to 13 (52.0 percent) out of 25 secondary transactions. This is in line with our hypothesis. In order to verify our indications we perform an independent sample *t*-test. Table 5.6.2.1 summarises the outcome of our test. Even though insignificant the tests indicate that the proportion of secondary buyouts exited in relation to new fundraisings is slightly higher than primaries. Consequently, we can conclude that the test is pointing in the same direction as our expectations.

Table 5.6.2.1 Primary and secondary buyouts exited in relation to a new fundraising

	No of trans.	Mean	Diff Prim-Sec
Primaries	85	0,3882	
Secondaries	25	0,5200	
Mean Diff			-0,132
T-stat			-1,171
Sign			0,244

5.6.3 Conclusion

Both our conducted interviews and our quantitative testing indicate a tendency towards PE firms divesting companies around the time of a new fundraising although our test is insignificant. Our interviews give several potential reasons to the observed phenomenon. The main explanation is that the PE firm might have to show new investors a track record in order for them to be willing to invest. Another suggestion is that the new investors demand increased focus on their fund, which requires selling investments in another fund. However, these explanations are somewhat limited since all transactions need to be economically defensible towards all investors. Lastly, when investors of the new fund are the same as for an old fund the capital might be limited and as a result the PE firm needs to exit some investments in order to reinvest the capital in the new fund.

5.7 Summary of Results

After testing the hypothesis it appears clear that, even though all performed tests were in line with our expectations, only the second and fifth hypotheses are supported at a statistically significant level. Table 5.7.1 summarises each hypothesis as well as the outcome from the testing.

Table 5.7.1 Summary of results from investigated hypothesises

Hypotheses	Support
H1: Secondary buyouts are positively related to favourable market conditions	No
H2: The buying PE firm has a larger fund than the selling	Yes
H3: The buying fund in a secondary buyout is more engaged in M&A activity	No
H4: Secondary transactions have different focus from primaries	No
H5: The investment is exited as the selling PE firm’s fund is reaching the end of its life	Yes
H6: The investment is exited since the PE firm is issuing a new fund	No

6. Regression analysis

In order to assess the explanatory power of our hypotheses we perform a regression analysis. Since the evaluated hypotheses are not the only grounds for investing in secondary buyouts we expect the explanatory power of our hypotheses to be relatively low. This expectation is further strengthened by the fact that many of our hypotheses have been proved insignificant in our previous tests. However, we hope that the regression can provide an indication of the hypotheses' relative importance and in that way support our results.

We perform a *Probit* regression, since it is the most accurate test to use for our rather limited sample. The *Probit* model is a generalized linear model with binary dependent variables (Altman et al 1981). For that reason it is useful in cases where the dependent variable can take two values, in our case primary transaction or secondary transaction. The model used is presented in equation 1.

Equation 1:

$$P(Y=1|X) = \Phi\,(\beta_0 + \beta_1 Boom\_bust + \beta_2 M\_A + \beta_3 Focus + \beta_4 Exit + \beta_5 Fundraising),$$

where Φ is the standard normal cumulative distribution function.

The dependent variable, Y, is defined as *1* for secondary transactions and *0* for primary transactions. Unfortunately we had to exclude the second hypothesis about the buying funds' larger sizes, since it is not possible to compare fund sizes in primary transactions. Table 6.1 summarizes the variables used in the regression as well as the coefficients' expected signs.

Table 6.1 Summary of variables used in the Probit regression and their expected signs

Hypothesis	Variable	Expected sign
H1	*Boom_bust*	+
H3	*M_A*	+
H4	*Focus*	+
H5	*Exit*	+
H6	*Fundraising*	+

Four out of our five variables are dummy variables defined as either *1* or *0*. The only hypothesis not defined with dummy variables is the third hypothesis about the increased level of M&A activity in secondary buyouts. When testing the *M_A* variable each transaction was assigned the number of acquisitions it had been involved in two years after a buyout. Table 6.2 shows a summary of the independent variables' definitions.

Table 6.2 Definitions of the independent variables

Independent Variables	Transaction defined as 1 if:	Transaction defines as 0 if:
Boom_bust	Transaction occurred during a boom period	Transaction occurred during a bust period
M_A	This variable is not a dummy variable but instead takes the value which corresponds to the accumulated number of acquisitions the target company has made two years after it was acquired	
Focus	Mentions focus on further operational development after the buyout	Does not mention focus on further operational development after the buyout
Exit	The exit occurred in the end of the fund's lifetime	The exit did not occur in the end of the fund's lifetime
Fundraising	The exit occurred in relation to a new fundraising	The exit did not occur in relation to a new fundraising

In order to evaluate if any of the variables have a larger explanatory value for secondary transactions we tested all variables together. The results from the *Probit* regression are presented in table 6.3.

Table 6.3 Results from the Probit regression analysis when testing the variables together

Parameter	Estimate	Z	Sign
Boom_bust	1,944	1,229	0,219
M_A	0,887	1,757	0,079
Focus	4,224	1,556	0,120
Exit	-3,013	-1,341	0,180
Fundraising	-2,002	-1,651	0,099

In line with our expectations and previous testing we find that the *boom_bust*, *M_A* and *focus* variables are positively correlated with secondary buyouts. The *M_A* variable is significant at a 10 percent level whereas the *boom_bust* and *focus* correlations are insignificant. In contrast, the *exit* and f*undraising* variables do not show the expected signs. Especially surprising is the fundraising variable since it is significant at a 10 percent level. A potential explanation to the unexpected signs could be that there is other variables not included in the model that also help explain the dependent variable. Furthermore, there is a possibility that the variables are affected by multicollinearity[5]. The estimated regression coefficients are less reliable if there is multicollinearity between two or more independent variables (Newbold et.al 2007). Hence, a possible explanation to the unexpected results could be that two or several of our variables are correlated. Multicollinearity could also be an explanation to why many of the coefficients are insignificant although the small sample size is most likely to be the reason to that.

When all variables were tested together 26 cases were valid. Using the probability of valid cases with a cut-off of 0.5 for classification it turns out that 92.3 percent (24 of 26 cases) of the cases is correctly classified as either a primary or secondary transaction. Thus, the variables used have a high explanatory power for this model.

In a second attempt to find significant results from the regression we excluded the variables *exit* and *fundraising* as they showed unexpected negative signs. This in turn allowed for a somewhat larger sample of 53 valid cases. The results are presented in table 6.4.

Table 6.4 Results from the Probit regression analysis excluding the exit and fundraising variables

Parameter	Estimate	Z	Sign
Boom_bust	1,467	2,402	0,160
M_A	-0,024	-0,252	0,801
Focus	0,606	1,528	0,127

We now find all variables to be insignificant and moreover, *M_A* now yields a negative sign. *Focus* and *boom_bust* have still positive signs although weaker than in the prior test. Just like the previous case, the absence of other variables not included in the model could have an affect on the outcome as well as the still relatively small sample size. Moreover, the results from this test are not completely comparable with the previous test as it is not based on the same observations.

Conclusion

When the variables are tested together we find that the *boom_bust*, *M_A* and *focus* coefficients offer the expected signs indicating that they are positively correlated to secondary transactions. *Exit* and *fundraising* both yielded opposite signs than expected. Therefore, we suspect that there are more variables than included in the model that help explain secondary

[5] Correlation between independent variables

transactions as well as a potential correlation between the explanatory variables. In addition, the small sample size makes it difficult to obtain significant results.

7. Conclusions and suggestions for further research

Private equity sponsored transactions are becoming ever more important in the Swedish market. In line with this development is the increased number of secondary buyouts and we believe that this relatively new transaction type will continue to expand as long as the market environment is favourable enough to create returns for investors. Previous studies within the private equity field have almost exclusively focused on the primary market. Our study uses the previous findings about the primary market as a base for investigating a representative data set of Swedish secondary transactions.

In our study we have used six different hypotheses to evaluate the rationales behind secondary investments. Each hypothesis has been tested separately with partly unique data. In addition to the quantitative studies, interviews have been performed with practitioners in the private equity market to gain clarifications and suggested explanations.

Firstly, in accordance with our expectations, our tests indicate that the proportion of secondary buyouts increases during favourable market conditions. It also appears significant that the buying fund in a secondary transaction is larger than the selling. In line with this conclusion is the result indicating that the buying funds in secondary transactions tend to be involved in acquisitions to a larger extent than the selling since that kind of activity often involves large capital investments. Another potential rationale behind secondary transactions is different focus between the primary and secondary investments and our results suggest that the sponsors in primaries focus more on operational improvements, while the sponsor in secondary transactions are relatively more involved in acquisitions and international expansion. Lastly, our results show that secondary investments tend to be exited in the latter part of a funds lifetime to a larger extent than primaries and in many cases the reason for exit appears to be that the private equity firm is raising capital for a new fund. These results indicate that the reason for exit is a sign of further value creation possibilities under a second PE owner. All findings are in line with our expected hypothesis even though only two out of six are significant.

In essence, we believe that our findings are a valuable contribution to the relatively unexplored secondary buyout market. Our study shows that there are several possible rationales to why a secondary buyout can be a beneficial investment, which strengthens their importance. We strongly believe that if the PE industry is here to stay, secondary buyouts are likely to increase, in absolute as well as relative terms.

We believe that there are three main areas for further research. Firstly, it is motivated to replicate this study in the future when the numbers of transactions have increased and more reliable conclusions can be drawn. More specifically, it would be interesting to evaluate the development of the PE industry if the market is heading towards a recession in order to observe if the proportion of secondary buyouts will increase or decrease. Secondly, if secondary buyouts are considered an extension of the PE industry it could be interesting to investigate the next potential expansion. Will PE firms continue to acquire targets from each other in never ending attempts to find further value creating potential and in that case what would that imply for the PE firms? We have already seen how secondary buyouts have demanded a slightly different strategy compared to primary buyouts. Thus, one possible outcome might be that the future PE firms will be more niche focused in terms of geographical areas or industries in the same way as companies are forced to specialise as competition increases. Lastly, our study is limited to six hypotheses even though there are numerous additional factors to investigate. A further investigation of secondary transactions' international expansion in relation to primary buyouts as well as if the target companies have varied characteristics in primary and secondary transactions would be interesting and provide a further clarification of the complexity associated with secondary transactions.

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Interviews: Summary in Appendix B

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Eliasson, J., Partner at Altor, Stockholm, 2007-12-04.

Rannaleet, A., Partner at Industri Kapital, Stockholm, 2007-10-18 and 2007-12-04.

Samuelsson, A., Director at Nordic Capital, Stockholm, 2007-12-03.

Stahlberg, J., Partner at EQT, Stockholm, 2007-12-06.

Other interviews: Not part of summary in Appendix B

Nordenstrom, J. Analyst, Adamsstreet Partners, London, 2007-10-05.

Stromberg, P., Associate Professor, Stockholm School of Economics, 2007.

Appendix A: Summary of interviews with the PE industry practitioners

The table below summarizes our main findings from the conducted interviews. For a specification of interviewees please consider the list of references. All interviews were based on the same themes, presented in Appendix B. However, in many cases the interviews preceded more like discussions and therefore the focus has been varying between the interviews. Consequently, all interviewees did not cover all topics. For this reason we do not divide the results between number of interviewees in favour and against our hypotheses but rather present arguments and ideas brought up during the discussions. Furthermore, our hypotheses are to a large extent related, which result in that some answers brought up apply to more than just one hypothesis. In this summary we have presented the answers based on what topic we were discussing, although they have in some cases been used in several of our hypotheses in section five.

Table 1: Summary of citations from the conducted interviews sorted by hypothesis

Hypothesis 1: The proportion of secondary buyouts is positively related to favourable market conditions

Citations in favour	Citations against
• We exit investments earlier then planned when we are offered a price high enough	• I do not believe that small PE players will disappear should we enter a recession
• If the market weakens, we will avoid investing in cyclical and other risky companies	• Talented investors will never lack capital to invest
• If we are facing an economic recession we expect to see longer holding periods	• Higher interest rates will have a minor effect on our operations. It is rather what higher interest rates implies in terms of market growth and profitability possibilities that could be critical
• All types of exits will decrease if the market conditions worsens	• The ROE is generally lower in secondary buyouts. Thus, they can be considered less risky
• Primary targets are fewer today	• The seller in secondary buyouts is an established market player and therefore concerned about remained reputation. For this reason the seller want to clarify the investment's current situation
• Primary buyouts often involve fairly obvious improvements, which are often less risky	• The possibility to increase the debt level is dependent on the company, not the owner
• If the equity level in one of our investments becomes too low we have the ability to add additional equity	• Leverage is more important for value generation in primary investments than in secondary buyouts
• When exiting our investments we always explain our plans with the company to the new owner. It is important that they realise	

the potential

Hypothesis 2: The buying PE firm has a larger fund than the selling fund

Citations in favour	Citations against
• The buying fund is almost always larger than the selling fund	
• More capital result in that more capital intense value generating activities, such as expansion, can be carried through	
• Growth and consolidation are the most important value generating activities	
• International expansion requires a lot of capital	
• Investing too much in one company increases the risk	
• When the fund is fully invested it is rather complicated to raise additional capital	
• When we acquire a company from another PE firm is natural that we pay a higher price than they once did as they are likely to have added value to the company	

Hypothesis 3: The buying funds in secondary buyouts are more engaged in M&A activity than the selling

Citations in favour	Citations against
• Growth is important in order to create value	• We are equally involved in M&A activities in our primary investments as in our secondary investments
• It is always attractive to make add-on acquisitions in order to try and consolidate the market and gain scale advantages	• The types of the acquisitions might vary. Primaries often involve mergers whereas secondary transactions might be more focused on i.e. international expansion.
• International exposure is important in order to be 'best in class'	
• PE firms generally have more knowledge about M&A than industrial or private owners	
• With new capital from a second PE owner it is easier to make add-ons	
• Primary transactions often need more fundamental improvements, such as	

operational restructurings. In those cases we need to focus on that rather than acquisitions

- I believe we focus slightly more on M&A in our secondary investments

Hypothesis 4: Secondary investments have different focus from primaries

Citations in favour

- A new owner might be suitable if they have useful specific knowledge
- When having invested in a new company, we generally start by taking care of internal restructurings
- In a secondary investment the "low hanging fruit" have generally been taken care of
- Primaries often focus on internal restructurings while secondary transactions often engage in other developments and often involve international expansion
- Secondary investments are often associated with more complex improvements
- A company has different stages in life. The targets' current position determines, to a great extent, what we will focus on
- Large PE firms do not want to get involved at a too early stage
- Companies that have been under a PE owner are generally well managed and seldom lacks important reporting systems
- Risk determines to some extent who is the most suitable owner
- A typical secondary company has no obvious synergies with other market players
- It is more difficult to find a buyer for a secondary than for a primary investment
- Secondary investments tend not to have a natural industrial buyer
- Companies bought from an industrial seller are in many cases relatively poorly managed

Citations against

- Swedish PE-firms are not specialized
- Specialization among Swedish PE-firms would drastically decrease the number of potential investments
- The international PE firms, i.e. in US are specialised to a larger extent. It is possible that we will become more specialized in the future
- Had it been possible, it could be beneficial to be an industry specialist
- There are always further improvements to make
- We look at the same value generating activities no matter if it is a primary or secondary investment
- It is crucial with a strong strategic focus on all types of investments
- The buyer of a secondary investment is not more senior nor experienced
- Non-core operations are almost always outsourced
- The selling PE firm prefers, assuming all other conditions equal, to sell through the secondary market

Hypothesis 5: The investment is exited since the selling PE owner's fund is reaching the end of its life

Citations in favour

- The most common exit reason for a PE-firm is that the fund is closing down
- Sometimes there is not enough time to capture all value potential
- We do not want to extend the life-time of a fund
- When we have realized our value creation plan, we sell-off the company
- More basic improvements such as report systems and organisation structure takes a long time to implement
- In some cases the strategy for primary targets include less change, partly since they are harder to predict beforehand
- If a fund is fully invested, there is no capital for further investments in a company
- We rarely move an investment from one of our funds to another due to the problems associated with such process
- We expect to exit our investments late in the fund's life
- In some cases a younger fund can be a more suitable owner since it has more time to carry through restructurings

Citations against

- During beneficial market conditions, our investments are sometimes realised earlier than planned
- The investments are sometimes exited earlier than planned when our pre-set strategy goes faster than expected
- During boom periods the PE firms sometimes benefit more from being "good investors" than "good developers"

Hypothesis 6: The investment is exited since the first PE owner is raising capital for a new fund

Citations in favour

- New investors sometimes want to see returns on previous investments
- We prefer having long relationships with our investors

Citations against

- We can not exit investments in one fund in order to focus on a new unless it is optimal, since the investors in the older fund would be disadvantaged
- We can not concentrate on too few investments since that increases the fund's risk

- The capital an investor is willing to invest is sometimes limited

- It is common that old investors invests in a new fund, sometimes they need capital from the older fund to be able to invest in the new

- New investors do not want us to focus on too many portfolio companies at once

- Investors with which we have worked for a long time are more forgiving if we fail to deliver the promised returns or if it takes longer than expected

- Sometimes we sell an investment earlier than planned in order to keep a high IRR

- It is possible to focus on few companies if they are diversified without increasing the risk

- If the exited investments have earned the fund the required return we can sell it earlier than planned

Appendix B: Question base for interviews

1. Secondary buyouts as a result of favorable market conditions?

- To what extent do the market conditions affect the investment and exit strategy? Does this vary between primary and secondary buyouts?
- Many critics argue that it will be tougher for the PE firms when interest rates are raised and the market becomes less liquid. Does the PE firms adapt to different market conditions and in that case how?
- Do you think that smaller PE firms will survive increased competition?

2. The buying fund is larger than the selling fund?

- Are the buying funds usually larger than the selling funds in secondary buyouts and in that case why?
- Are there any reasons related to market conditions or focus/strategy?

3. M&A activity?

- Is it more common to focus on M&A activity in a secondary buyout compared to in a primary buyout? Why?

4. Secondary buyouts have different focus from primary transactions?

- What are the most common operational improvements?
- How can there be further potential improvements in a secondary buyout?
- When is it beneficial to sell a company and let the new owners carry through further improvements?
- Why do you not do all improvements yourselves? Due to time aspects?
- Have a company’s different development stages any consequences? How?
- Is the buying fund generally more experienced/senior than the selling in a secondary transaction?
- What are your criteria for a future target company?
- Are different PE firms unequally picky about the quality of their targets?
- Are secondary buyouts a result of lacking primary investments? Are they equally profitable?
- Give an example of a difference between a primary transaction and a secondary buyout that you have been involved in. What was the underlying strategy?

5. The fund is closing down as a reason for exit?

- What factors do you consider when you are about to decide when to exit an investment?
- Do you have a shorter perspective regarding the holding period for a primary compared to a secondary investment?
- Are there any differences between primary and secondary buyouts with regards to at what point in time of a fund’s lifetime the investment is made?

6. A new fundraising as a reason for exit?

- What is the optimal number of investment companies to have in a fund?
- Is it common that the same investors invest in more than one of your funds?
- Do you tend to divest some of your holding companies when you are about to raise money for a new fund? Why?
- Do you think that PE firms sometimes need to show new investors realized returns?

Appendix C: Summary of hypothesis four – Focus areas for secondary transactions

Target	Buyer/Investor	Seller	Development	Acquisitions	International
Nybron Flooring International	Vestar Capital Partners	HIAG, Nordic Capital		x	x
Molnlycke Health Care	Apax Partners	Nordic Capital	x		
Nycomed	Nordic Capital	Blackstone, DLJ Merchant banking		x	
Hilding Anders International	Investcorp	Nordic Capital, Ratos AB, Skandia Investment		x	
Schenck Process	Industri Kapital	HgCapital		x	
Q-matic	Altor	3i Group, Litorina Kapital	x		
DYWIDAG-Systems International	CVC Capital Partners	Industri Kapital	x		
Eltel Networks Corporation	3i Group	Industri Kapital	x	x	x
Pasteur Cerba	Industri Kapital, Astorg Partners, Intermediate Capital	Astorg Partners	x	x	x
Minimax	Industri Kapital	Investcorp		x	x
Perstorp Group	PAI partners	Industri Kapital	x		
Intrum Justitia	Burdaras Hf, Cevian, Landsbanki Islands	Industri Kapital		x	x
Bonna Sabla	Industri Kapital	AXA Private Equity	x		x
SIA	Industri Kapital	3i Group	x		
LAHO Equipement	Barclays Private Equity	Industri Kapital	x	x	
CEVA Sante Animale	Industri Kapital	PAI partners	x	x	
Paroc Group	Bank of America	Industri Kapital, Partek Corp	x		
Salcomp	Nordstjernan	EQT	x		
Contex	Ratos	EQT	x	x	
Com hem	Providence, Carlyle	EQT	x		x
FlexLink	ABN Amro	EQT	x	x	
Thule	Candover	EQT	x		
QM Group	Altor	Advantage Capital			x
TOTAL			**16**	**12**	**8**

Appendix D: Summary of hypothesis four – Focus areas for primary transactions

Target	Seller	Buyer/Investor	Development	Acquisitions	International
Dynapac	Metso Corporation Oyj	Altor	x		
Com hem	Telia Sonera	EQT	x		
Bewator Holding	Elmby gård	EQT	x	x	
Symrise	Bayer	EQT		x	
FlexLink	AB SKF	EQT	x	x	x
Plantasjen	Bröderna Gylterud et al	EQT			
Hymite A/S		Industri Kapital AB; TVM Capital Buyer Funds	x	x	
Consolis Oy		Industri Kapital	x	x	x
DYWIDAG-Systems International	Walter Bau	Industri Kapital	x	x	
Eltel Networks	Cap Man	Industri Kapital AB	x		
Gardena		Industri Kapital	x		
Labeyrie	Suez	Industri Kapital	x		
CPS Color	Kemira Oyj	Industri Kapital	x		x
LAHO Equipement		Industri Kapital	x	x	x
Alfa Laval	Tetra Laval Group	Industri Kapital	x		
Fortex		Industri Kapital	x	x	
Dyno Nobel		Industri Kapital	x		
Personec Group	Tieto Enator	Nordic Capital			x
Dangaard Telecom Holding		Nordic Capital	x		
Tradimus		Nordic Capital		x	
Nycomed Pharma	Amersham	Nordic Capital	x		
Falck		ATP Private Equity Partners, Nordic Capital	x		
Aditro		Nordic Capital	x		
Molnlycke Health Care Group	Tamro Oyj	AP Fonden 6, Bure Equity, Nordic Capital	x	x	x
Anticimex	TMX-Europe	Nordic Capital	x		
Dynal Biotech	A.L. Industrier, Dynea International Oy, Dyno Nobel	Nordic Capital, Ratos			
BRIO Lekolar	Brio AB	Procuritas	x		
Expan	Euroc Beton, H+H International	Procuritas	x		
TOTAL			**23**	**10**	**6**