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Secondary Buyouts—Creating or Destroying Value for Investors?

In the past, private equity (PE) firms seeking to exit sold their portfolio companies to another company in the same industry or organized an IPO. Today, almost half of PE exits are secondary buyouts (SBOs). Do SBOs create or destroy value for investors?

Twenty years ago, private equity (PE) firms seeking to exit sold their portfolio companies to another company in the same industry or organized an IPO. Nowadays, 40 percent of PE exits occur through secondary buyouts (SBOs), transactions in which a PE firm sells a portfolio company to another PE firm. The rise of SBOs has elicited concerns among PE investors (the limited partners with stakes in private equity funds): Does the rise of SBOs mean that PE firms have run out of investment ideas? Do SBOs create or destroy value for investors? In their forthcoming Journal of Financial Economics article "On Secondary Buyouts" François Degeorge (USI Lugano), Jens Martin (University of Amsterdam and former SFI PhD at USI Lugano), and Ludovic Phalippou (Oxford University) provide answers to these questions.

Investor concern #1: "SBOs? Just a financial version of pass the parcel."

One often heard concern among investors is that SBOs are just pass-the-parcel deals in which the main motivations for the buying PE fund are to spend capital and collect fees. This suspicion arises from a certain distinctive feature of private equity funds: they have a finite period in which to invest their capital, after which time general partners usually earn management fees only on the invested portion of the capital committed by investors. This feature generates a conflict of interest between a fund's general partners and investors: if a fund has excess capital close to the end of the investment period, a general partner has an incentive to "burn money" by taking bad deals. SBOs are plausibly a preferred investment channel for a fund wishing to burn money: they are easier to source than other buyouts (the companies owned by private equity firms are publicly known) and less likely to be "lemons" (any company present in the portfolio of another PE firm is a priori up for sale.)

Using a large dataset of buyouts, Degeorge, Martin, and Phalippou find evidence of money-burning in SBOs, but only in those carried out late in the investment period of the buying fund. Such SBOs underperform other buyouts, while at the same time exhib-

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The full paper can be found at http://bit.ly/1Nx88mP.

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iting slightly higher risk. Net of fees, these late-period SBOs return USD 0.88 on average when an investment in the stock market index would have returned USD 1. Investors penalize funds that burn money in SBOs by voting with their feet, reducing their participation in the next fund raised by the same private equity firm. SBOs carried out early in the investment period perform as well as other buyout transactions and generate a positive NPV for investors, similar to other buyout transactions.

Investor concern #2: "How can a second PE owner add value relative to the first PE owner?"

A second often expressed concern about SBOs is what additional value, if any, the buyer can bring to the portfolio company compared to that brought by the first private equity owner. The authors uncover an important source of value creation in SBOs: the presence of complementary skill sets between the buyer and the seller. Based on the educational backgrounds and career paths of the general partners of PE funds the authors classify PE firms as finance-oriented or operations-oriented, and MBA-dominated or not MBA-dominated. Based on the geographical presence and strategies of PE firms they classify them as regional or global, and as "margin-growers" or "sales growers". They find that SBO transactions between firms with complementary skill sets generate significantly higher returns for buyers than SBOs between firms with similar skills. Moreover, they find that the net-of-fees net present values of SBOs that took place between two complementary PE firms are large and positive. In contrast—and consistent with the aforementioned second concern, regarding SBOs and additional value—in the absence of complementary skill sets transactions between funds do not generate value for investors.

Investor concern #3:"When you own stakes in several PE funds, you can find yourself on both the buying and the selling side of an SBO. Isn't that just a tax on investors?"

The third often expressed concern about SBOs relates to the situation known as "limited partner overlap." Investors often have stakes in several private equity funds. As a result, investors can find themselves on both the buying side and the selling side of an SBO transaction. Consequently, they end up owning the same asset after the transaction, but have paid large transaction costs; some observers equate this situation with a tax on investors.

Degeorge, Martin, and Phalippou show that this concern is largely unwarranted, at least if one takes as given two key features of PE funds: the fact that PE funds have a finite life, so that all investments need to be exited sooner or later, and the fact that general partners always invest the capital committed by investors. As a result, for every dollar invested in a fund, investors pay two rounds of transaction costs: one when the dollar is invested and another when it is divested. This accounting identity holds true regardless of the transactions undertaken by the general partner (SBOs with or without limited partner overlap, sale to a strategic buyer, or IPO).

To be sure, the fact that general partners never return capital to investors is unlikely to be value-maximizing for limited partners: it might well result from general partners' incentives to burn money. The probable reason why limited partners are uneasy about SBOs with limited partner overlap is that two salient features of such deals expose general partners' reluctance to return capital: the simultaneity of entry and exit costs, and the fact that the limited partner ends up owning the same asset after the SBO.

Overall, "On Secondary Buyouts" paints a nuanced picture of the phenomenon and suggests that not all SBOs are created equal: SBOs between PE funds with complementary skills generate value for investors; others do not. SBOs carried out under the pressure to burn money destroy value for investors; others do not. SBOs with limited partner overlap do not generate extra transaction costs for investors, but only under the assumption that each dollar committed will be spent—an assumption that, while true in practice, is unlikely to be value-maximizing for investors.

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