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On secondary buyouts[☆]

Francois Degeorge[a], Jens Martin[b], Ludovic Phalippou[c,d,*]

[a] Swiss Finance Institute, Università della Svizzera italiana, Lugano, Switzerland
[b] University of Amsterdam, Netherlands
[c] University of Oxford, Saïd Business School, Park End Street, Oxford OX1 1HP, UK
[d] Oxford-Man Institute, Oxford OX2 6ED, UK

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ABSTRACT

Private equity firms increasingly sell companies to each other in secondary buyouts (SBOs), raising concerns which we examine using novel data sets. Our evidence paints a nuanced picture. SBOs underperform and destroy value for investors when they are made by buyers under pressure to spend. Investors then reduce their capital allocation to the firms doing those transactions. But not all SBOs are money-burning devices. SBOs made under no pressure to spend perform as well as other buyouts. When buyer and seller have complementary skill sets, SBOs outperform other buyouts. Investors do not pay higher total transaction costs as a result of SBOs, even if they have a stake in both the buying fund and the selling fund.

1. Introduction

Transactions known as secondary buyouts (SBOs), in which a private equity firm sells a portfolio company to another private equity firm, have evolved from a rarity in the 1990s to 40% of private equity exits in recent years (Strömberg, 2008). The rise of SBOs has elicited concerns that such transactions cannot create value, and even that they predictably destroy value, for private equity investors (the limited partners with stakes in private equity funds). Given that private equity (PE) funds manage about $3 trillion worldwide, it is important to empirically assess the validity of the claims made about a large fraction of transactions in this asset class. Such is the goal of this study.

The first claim we address is that SBOs are just “pass-the-parcel” deals in which the main motivations for the buying fund are to spend capital and collect fees. This suspicion arises from certain distinctive features of private equity funds: they have a finite period in which to invest their capital, after which time general partners usually

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* Corresponding author at: Saïd Business School, University of Oxford, Park End Street, Oxford OX1 1HP, UK. Tel.: +44 1865 288719.
E-mail address: Ludovic.Phalippou@sbs.ox.ac.uk (L. Phalippou).

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earn management fees on the invested capital. Axelson, Strömberg and Weisbach (2009) note an agency conflict between general partners and investors: if the fund has excess capital near the end of the investment period, then a general partner has an incentive to "burn money" by taking bad deals. SBOs are plausibly a preferred investment channel for such a fund: they have lower search costs than other buyouts (the companies owned by private equity firms are publicly known) and lower adverse selection problems (any company present in the portfolio of another PE firm is a priori up for sale.)

A second concern is what additional value, if any, an SBO buyer can bring to the portfolio company compared to that of the first private equity owner. Conceivably, a buyer with complementary skills to those of the seller might be able to further enhance the value of the portfolio company, but the academic literature is largely silent on what these complementarities might be.

Third, 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 to a tax on investors.

Our empirical analysis relies on several large data sets, some of them hand-collected. Our sample includes 5,849 buyouts for which we have precise returns data. Our main findings are as follows. Our evidence is partially consistent with the money-burning view of SBOs. We find that SBOs made late in the buying fund's investment period, when the fund is under pressure to spend capital, underperform other buyouts, while at the same time exhibiting slightly higher risk. Controlling for a number of factors, the Public Market Equivalent (PME) of late SBOs is about 0.3 lower on average than for comparable buyouts. Late SBOs generate negative Net Present Value (NPV) for the limited partners invested in the buying fund: net of fees, late SBOs return $0.88 on average when an investment in the stock market index would have returned $1. The follow-on-funds of funds that made late SBOs are markedly smaller, consistent with the view that the investors penalize funds that burn money: investing in late SBOs appears to be a short-lived trick for general partners.

SBOs made early in the investment period, which represent nearly two-thirds of our sample, perform as well as other buyout transactions and generate a positive NPV for investors, similar to other buyout transactions. The follow-on-funds of funds that engage in SBOs early in their investment period are not penalized by investors: they raise funds of similar size as those that do not engage in SBOs, suggesting that investors are not dissatisfied with funds doing early SBOs.

We uncover an important source of value creation in SBOs: the presence of complementary skill sets between the buyer and the seller. To identify PE firm skill sets we construct two novel data sets on the educational backgrounds and career paths of the general partners (GPs) of PE funds, as well as on the strategies pursued by private equity firms in their portfolio companies. We collect biographical information on the 1,978 general partners of 138 PE firms, and financial performance information on 2,137 companies owned by 121 PE firms. Using this unique detailed data, we classify PE firms as Finance-oriented or Operations-oriented; MBA-dominated or not MBA-dominated; regional or global; and "margin-grower" or "sales grower." We find that SBO transactions between firms with complementary skill sets generate significantly higher returns for buyers than SBOs between firms with similar skills. Moreover, we find that the net-of-fees NPV of SBOs that occurred between two complementary PE firms is large and positive. In contrast, and consistent with often expressed concerns about SBOs, transactions between funds without complementary skill sets do not generate value for investors.

Finally we investigate the situation known as "LP overlap," in which limited partners (LPs) in private equity funds find themselves on both the buying and the selling side of an SBO transaction. We show that, assuming that GPs never return capital to investors (an assumption that is almost always met in practice) the widespread view is incorrect: SBOs do not, as commonly believed, generate extra transaction costs for limited partners involved in both sides of the transaction. Yet the eventuality of LP overlap is relevant for limited partners' allocation decisions to PE funds: by investing in funds with complementary skills, limited partners stand to gain more from their PE investments, should they find themselves on both sides of an SBO transaction.

Previous studies have documented some other agency costs of private equity funds: Axelson, Jenkinson, Weisbach, and Strömberg (forthcoming) suggest that they use too much leverage; Gompers (1996) and Robinson and Sensoy (2013) find that funds exit good deals too early; Lopez-de-Silanes, Phalippou and Gottschalg (forthcoming) find that some funds raise too much money.

Other contemporaneous studies examine secondary buyouts empirically and present results that are complementary to ours. Unlike this paper, most focus on the corporate finance side of SBOs. Wang (2012), Jenkinson and Sousa (2012), and Bonini (forthcoming) find that, on average, SBOs exhibit smaller operating performance gains than other buyout transactions. Achleitner and Figge (2014) find low average returns for SBOs compared to other buyout transactions.

The most closely related study is that of Arcot, Fluck, Gaspar and Hege (2015). Arcot et al. make a comprehensive study of the determinants of SBO activity, something we do not examine here. They find that: buying pressure makes buying an SBO more likely; selling pressure makes an exit via SBO more likely; buying pressure dominates selling pressure; and greater fund specialization (by size or industry) does not make SBOs more likely. In addition, they find that buying pressure makes buyers pay more and syndicate less, and that selling pressure depresses valuations.

Both Arcot, Fluck, Gaspar and Hege (2015) and our paper study the investment performance of SBOs. Arcot, Fluck, Gaspar and Hege (2015) infer deal performance from the growth rate of enterprise value, whereas we have access to the equity return obtained by the GP. Both their study and ours find that money-burning incentives are associated with worse SBO investment performance.