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Fund managers under pressure: Rationale and determinants of secondary buyouts ☆

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ABSTRACT

The fastest growing segment of private equity (PE) deals is secondary buyouts (SBOs)—sales from one PE fund to another. Using a comprehensive sample of leveraged buyouts, we investigate whether SBOs are value-maximizing, or reflect opportunistic behavior. To proxy for adverse incentives, we develop buy and sell pressure indexes based on how close PE funds are to the end of their investment period or lifetime, their unused capital, reputation, deal activity, and fundraising frequency. We report that funds under pressure engage more in SBOs. Pressured buyers pay higher multiples, use less leverage, and syndicate less suggesting that their motive is to spend equity. Pressured sellers exit at lower multiples and have shorter holding periods. When pressured counterparties meet, deal multiples depend on differential bargaining power. Moreover, funds that invested under pressure underperform.

1. Introduction

> *Deal intermediaries in London now use a not very flattering label for fund managers facing pressure to invest their capital promptly: 'desperate housewives'. […] If you are a banker shopping a company, you track down those managers with unspent capital in their aging funds, struggling to extend their investment period and, crucially, who can't raise new money until the tail is gone. They are basically dying to do a deal, at almost any price. Given this flurry of activity [in secondary buyouts], it is hard to resist the conclusion that desperate housewives are indeed at large.*
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> Private Equity International, June 10, 2010

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After three decades of tremendous growth, private equity (PE) is now an established industry with more than 13,000 funds and around $3 trillion dollars of assets under management, mostly dedicated to leveraged buyouts (LBO).[1] Among all PE transactions, the highest rate of growth in recent years was realized in secondary buyouts (SBOs), deals in which one PE fund sells a portfolio company to a competitor fund. SBOs now constitute more than one-third of observed LBO exits.

Both efficiency and opportunistic motives can potentially explain why so many PE funds choose to invest or exit this way. According to Jensen (1986), PE funds have superior governance structures and incentive mechanisms. It follows that when they engage in secondary transactions, it is likely to be in the best interest of their investors. If, for example, PE funds specialize in different stages of restructuring, then funds specializing in the first stage would sell to those with expertise in the second stage and each fund would create value for its own investors along the way. Alternatively, some general partners (GP) may have unique skills that others do not possess and when their funds acquire firms from other funds, they generate additional returns. For example, more reputable funds may have better access to deal financing.

A second view, in contrast, suggests that part of the growth in secondary deals might be due to self-serving GPs who place their own interest ahead of their investors.[2] On the buy side, when a PE fund has been unsuccessful to invest in traditional deals, it may resort to SBOs that are quicker to complete, fill the fund's investment record, reduce non-invested capital in anticipation of a new round of fundraising, and accrue additional management fees even if the transaction is not in the best interest of the buyer's limited partners (LPs). On the sell side, SBOs offer a quick exit for GPs who cannot sell via trade sale or Initial Public Offering (IPO) and that need to liquidate an existing fund or show activity to their LPs ahead of fundraising. Hence, secondary buyouts could be the preferred option for GPs with adverse incentives who wish to conclude a deal quickly.

The objective of this paper is to investigate the impact of PE fund incentives on the decisions to invest and exit via a secondary deal. Using a combination of fund characteristics, we create a Buy pressure index and a Sell pressure index to detect PE funds prone to opportunistic behavior. We then analyze in a large buyout sample the investment and exit choices of funds under pressure, as well as transaction multiples, use of leverage, syndication, and performance.

To identify PE funds which are more likely to face conflicts of interest, we consider the typical contractual provisions in partnership agreements between GPs and LPs. The former are expected to invest during the first five years of the fund's life, called the investment period. The management fees are set to provide incentives to invest early, with GPs being paid a percentage of committed capital during the investment period, and a percentage of net invested capital during the subsequent period, the harvesting period.[3] However, for PE funds with substantial "dry powder" (unspent capital) close to the end of their investment period, this provision creates adverse incentives to invest in deals that GPs would otherwise have rejected at the start of the fund. This intuition has been formalized in the optimal contracting model of Axelson, Strömberg, and Weisbach (2009).

PE sponsors aim to raise a new fund every three to five years, and their reputation and track record are critical for their ability to do so (Kaplan and Schoar, 2005; Chung, Sensoy, Stern, and Weisbach, 2012). The pressure of being evaluated during each fundraising cycle is part of the GPs' implicit incentive mechanism. As Chung, Sensoy, Stern, and Weisbach (2012) show, a major part of GPs' lifetime compensation is the expected income from subsequent funds. Prospective LPs not only look at past performance but also at the investment track record of the sponsor's recent funds. If the most recent fund still has a substantial amount of unspent capital near the end of its investment period, the LPs are unlikely to commit capital to a new fund. This puts further pressure on PE funds to invest their dry powder in order to boost their investment record. Funds with little reputational capital have more to gain from doing so, and hence have a potentially stronger incentive distortion.

For funds in their harvesting period, the closer the end of their lifetime (typically ten years) or the more time has passed since their last exit, the more exit pressure they face. GPs with substantial non-exited investments will be tempted to sell quickly to another PE fund, in order to improve their chances to raise new capital. Funds may also strategically delay exits with modest proceeds in order to collect management fees (Robinson and Sensoy, 2013a) and those that do so would presumably find themselves more frequently under selling pressure. Hence, one would expect to see lower multiples on exits by pressured sellers. Again, GPs with lesser reputation would have more to gain from engaging in such exits.

For our identification strategy it is crucial that there is a dynamic incentive provision story at play over the fund's lifetime. For funds early in their investment period, the pressure from the PE contract is most likely positive and value-enhancing. However, for funds late in the investment period with substantial dry powder, the same contract may potentially create adverse incentives to window dress. As the two-period optimal contracting model of Axelson, Strömberg, and Weisbach (2009) demonstrates, funds that invest early invest exclusively in positive net present value (NPV) projects and will continue to do so late in their investment period (in the second period of the model). In contrast, PE funds that have not found good investments early are willing to lower their investment threshold late in their investment period to keep management fees and improve their fundraising prospects. Axelson, Strömberg, and Weisbach (2009) predict that it is the combination of fund age and dry powder that makes

[1] *Source*: Preqin, Private Equity Spotlight, August 2012.

[2] See, e.g., *Private-equity companies look to each other to solve their problems*, The Economist, February 23, 2010.

[3] Net invested capital is calculated as the cost basis of all investments less the cost basis of realized investments.