PitchBook

Echo Buyouts

An analysis of secondary buyouts from the investor perspective

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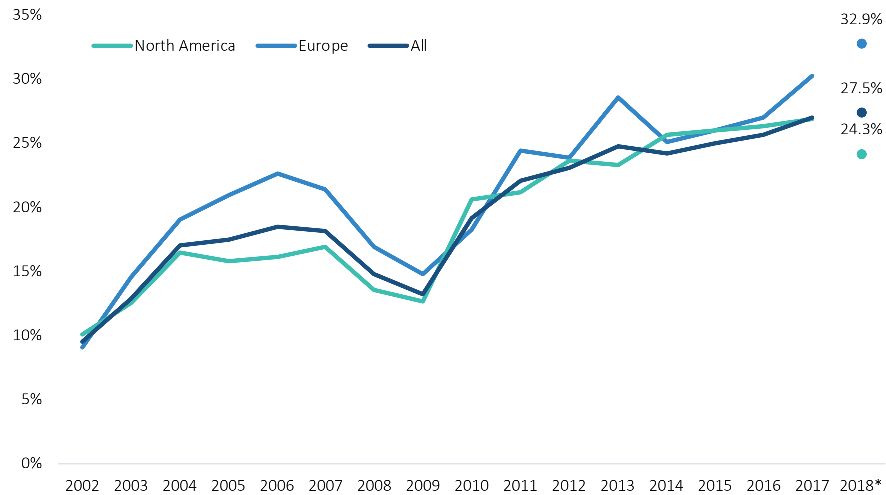
Key takeaways

- **Secondary buyouts (SBOs) are now an integral deal sourcing channel.** SBOs currently account for more than one-quarter of buyout deals, up from 15% in 2008.
- **SBOs often require more operational work, but that does not mean longer hold times**. Portfolio companies tend to undertake more add-on deals as they go through subsequent rounds of PE ownership. At the same time, however, the median hold time is lower for companies that have had two or more PE backers.
- **Certain companies and business models are more conducive to PE ownership/SBOs.** General partners (GPs) that acquire a company through an SBO are more likely to use an SBO as the exit route, supporting findings from previous research that suggest certain businesses are better suited for PE ownership.

Global SBOs as % of non-add-on LBOs



Source: PitchBook
*As of May 2018

As the PE industry has matured, SBOs have become an increasingly crucial deal sourcing strategy for buyers and a more frequently used exit channel for sellers. SBOs currently account for more than one-quarter of buyout deals—a proportion that has risen nearly unabated for almost two decades. Furthermore, the number of companies that have undergone multiple SBOs—a situation we have dubbed "echo buyouts"—is also on the rise; more than 20% of the SBOs executed in 2017 represented the third buyout of the target company, while 8% were the fourth or more buyout (not including add-ons).

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Because there is a finite number of potential targets, this rise in SBOs was an inevitability as PE attracted more capital and more companies came under PE ownership, with the current tally at more than 12,000 globally. In addition to structural changes to the PE industry, current dynamics—namely high levels of dry powder and lengthening hold times for portfolio companies—should only perpetuate the SBO trend in the coming years. As such, while many trends in financial markets are cyclical, we think that the proportion of SBOs is unlikely to revert to historical levels.

The decision to exit via an SBO is relatively uncontroversial—if a PE firm is the highest bidder, awarding them the deal is a simple decision for the seller. But SBOs from a deal sourcing perspective historically have been more contentious, with a primary concern being that subsequent PE backers will find it difficult to explore new ways to unlock value. And if GPs are able to find value in SBOs, will it take them longer to realize it? In this note, we examine these deals from several aspects to identify how they differ from non-add-on primary buyouts (PBOs) and to better understand the changing role of SBOs.

What makes you so special?

Existing research into the performance of SBO deals has painted an inconclusive picture, with SBOs underperforming in some circumstances but delivering superior returns in others. Specifically, researchers have found that “SBO transactions between firms with complementary skill sets generate significantly higher returns for buyers than SBOs between firms with similar skills” (Degeorge, Martin & Phalippou, 2015). This specialization can come in many forms, including sector expertise.

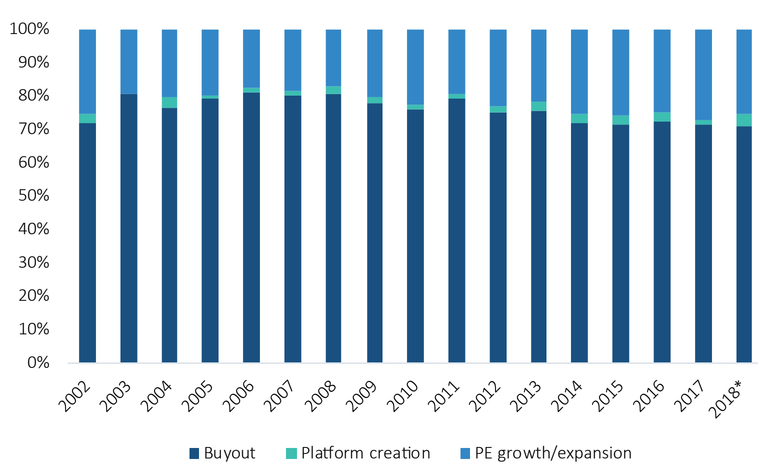
At the sector level, we find that SBO activity largely mirrors that of PBOs. One notable exception, however, is in the B2C space, which has represented 26% of SBOs over the last decade but just 20% of PBOs. We attribute this to the B2C sector’s composition of companies with relatively straightforward business models that potentially fit into a wide range of PE strategies. Unsurprisingly, the B2B sector—another generalist category—is the most active space for SBOs.

Conversely, more niche sectors including IT, financial services and healthcare have attracted fewer SBO investors. But this is beginning to change, especially with the IT sector, which has seen its share of SBOs climb from the high single digits in the late-2000s to nearly 15% in 2017. We expect this trend to continue as the number of specialized firms and funds in this space continues to proliferate.

What is an SBO?

The concept of an SBO seems relatively straightforward, but nothing in private markets is ever as simple as it seems. One of the biggest confounding factors is how to treat growth equity deals where a PE firm acquires a minority controlling stake in a company. A common situation we encounter is that a company receives a growth equity investment and is subsequently bought out by a different PE firm. Since this represents one PE firm selling to another, we classify this transaction as an SBO, despite the fact that the transaction was preceded by a growth equity deal, as opposed to a buyout. For the last several years, roughly one-quarter of SBOs involved companies in which the selling PE backer’s initial investment was growth equity rather than an LBO.

Global SBO deals (#) by prior PE deal type



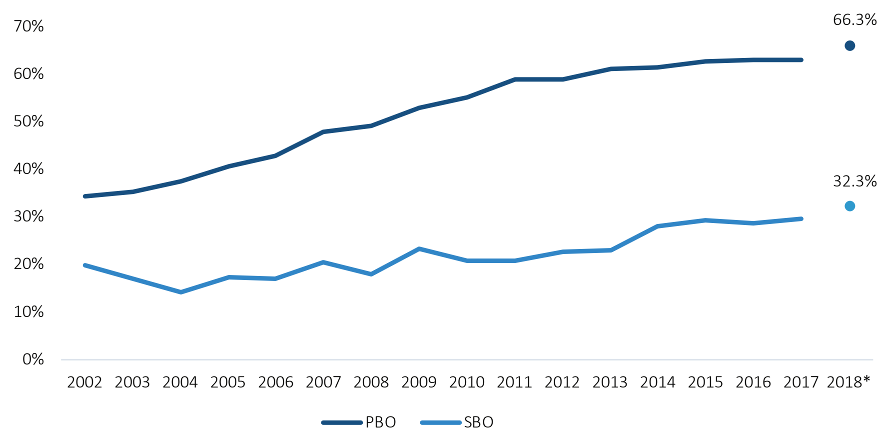
Source: PitchBook
*As of May 2018

In addition to sector specialization, GPs are increasingly touting their bona fides as they relate to shepherding companies through a particular stage of their lifecycle. While one GP may be adept at taking a company from $5 million to $20 million in EBITDA in its domestic country, another GP may be better equipped to fuel the company's future expansion into foreign markets. In many ways, this mirrors the common refrain in the VC community that different CEOs are often needed to guide companies through various stages of development. We will further investigate this supposition in a future analyst note.

No assembly required

When considering SBOs from a deal sourcing perspective, it is important to understand how these deals are used within a broader PE fund, specifically their role within the buy-and-build strategy—a phenomenon that has altered the PE dealmaking landscape. We find that GPs are less inclined to use SBOs as add-ons, with the gap widening over the last decade while there has been a rampant rise in overall add-on activity. Roughly two-thirds of PBOs in 2017 were add-ons, compared to just one-third for SBOs. One reason for this dichotomy is that companies targeted for add-on transactions are often too small or undeveloped to make sense as a standalone platform, whereas a company acquired via SBO is by definition more developed in this regard.

Global % of deals that are add-ons



Source: PitchBook
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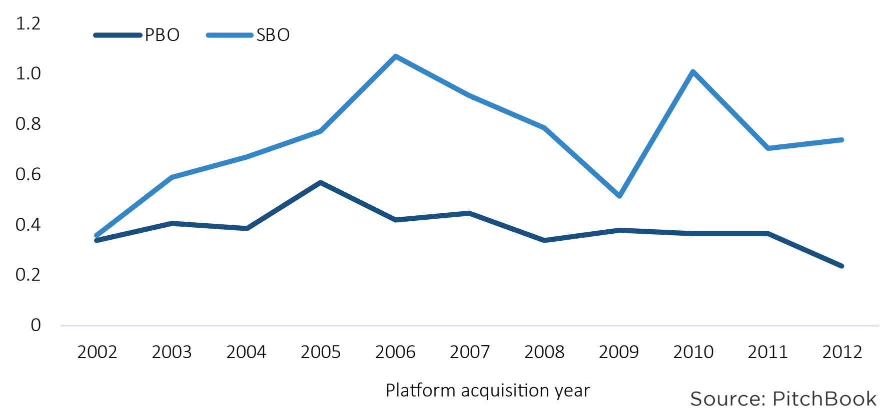
While SBOs themselves are infrequently used as add-ons, sponsors of SBOs have embraced the buy-and-build strategy as a value creation lever. From 2002-2012, GPs completed an average of 0.39 add-ons per platform acquired via PBO, with that figure nearly doubling to 0.74 add-ons for companies that had undergone a single SBO. Interestingly, the rate of add-on deals jumps again if and when companies come under their third or more round of ownership, with these platforms averaging 0.97 add-ons per platform over the same period. We anticipated this finding when we began our analysis, operating under the assumption that subsequent PE owners would have more limited options for driving returns through traditional means like organic growth, cost cutting and financial engineering.

Global add-ons per platform

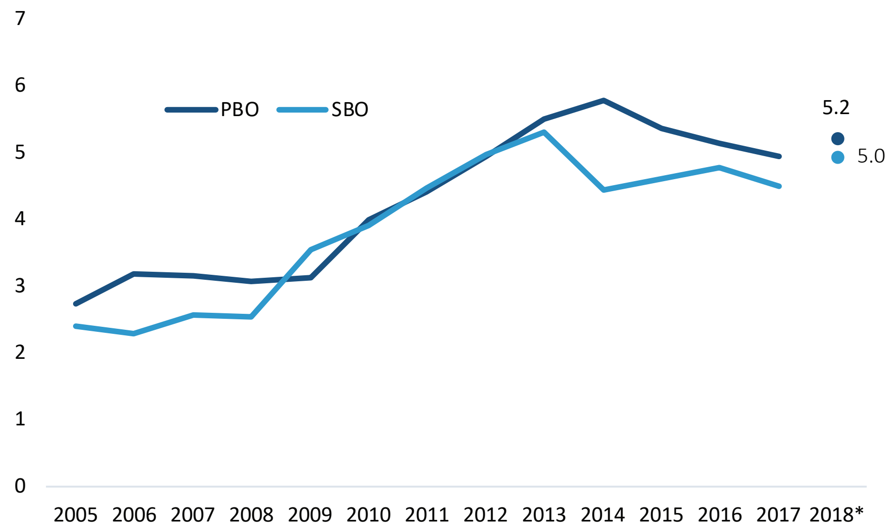


Source: PitchBook

Any juice left?

A presumed knock-on effect of more add-ons is a longer hold time for the platform company, but that does not appear to be the case. Indeed, perhaps the most surprising findings in our analysis of SBOs are related to the holding period of investments. Our hypothesis was that it would take longer to exit companies acquired via SBOs, assuming it would require more time for a subsequent PE backer to generate adequate value in the investment. But this has rarely been the case; in 2009, the median hold time at exit for companies acquired via SBO was 3.5 years, compared to 3.1 years for PBOs. Hold times extended across the board in the wake of the financial crisis as buyers balked and the IPO market dried up, but the extension in hold times was more pronounced for PBOs than SBOs. To that end, we saw the trend in hold times begin to diverge in 2013, with companies acquired via PBO being held longer than their SBO counterparts, which has persisted into 2018.

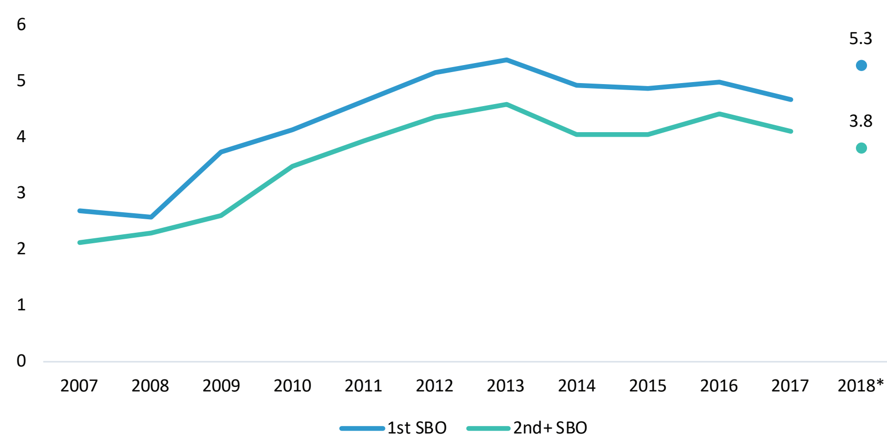
Global median time to exit (years) post entrance via PBO or SBO



Source: PitchBook
*As of May 2018

Going one level deeper, we also find that the median time to exit drops even further as a company experiences additional rounds of PE ownership. One explanation for these seemingly counterintuitive findings in hold times is that potential SBO buyers face heightened scrutiny—from their own investment committees and from limited partners (LPs)—when pursuing targets that have already been through PE ownership. As such, the investment thesis and value creation initiatives (e.g. 100-day plan) in these situations are likely to be even more finely tuned than in other deals. And those pressures should only increase with each additional round of PE ownership, leading subsequent buyers to create more definitive paths to exit.

Global median time to exit (years) post entrance via SBO



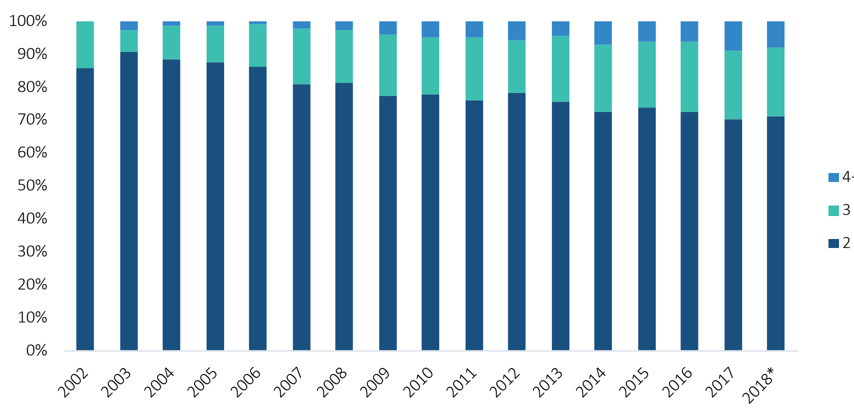
Source: PitchBook
*As of May 2018
Note: Insufficient sample sizes prior to 2007

Revolving door?

We have seen an increasing propensity of portfolio companies to come under three or more rounds of PE ownership.

Another explanation is that certain companies and business models are more conducive to PE ownership—a claim that has been posited by numerous researchers (e.g. Jensen, 1989; Kaplan, 1991; Strömberg, 2008). This bears itself out in the data in other ways too. First, we have seen an increasing propensity of "echo buyouts," whereby portfolio companies come under three or more rounds of PE ownership. As with other trends in SBOs, this metric was bound to rise over time, but the trend line is still noteworthy. An examination of the exit route chosen by GPs also suggests

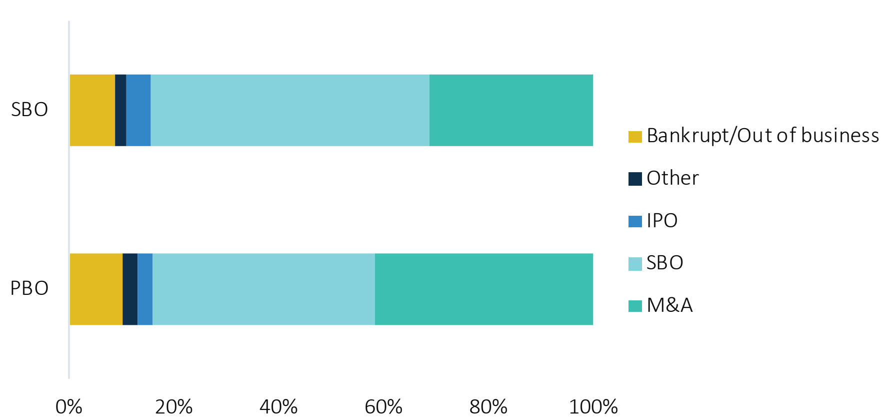
Global SBOs (#) by number of total LBOs



Source: PitchBook
*As of May 2018

that certain businesses are more apt for SBOs. From 2008-2017, SBOs accounted for more than half (53%) of the exits for portfolio companies acquired via SBO, compared to just 42% for PBOs.

Global exits (#) by type (2008-2017) post entrance via PBO or SBO

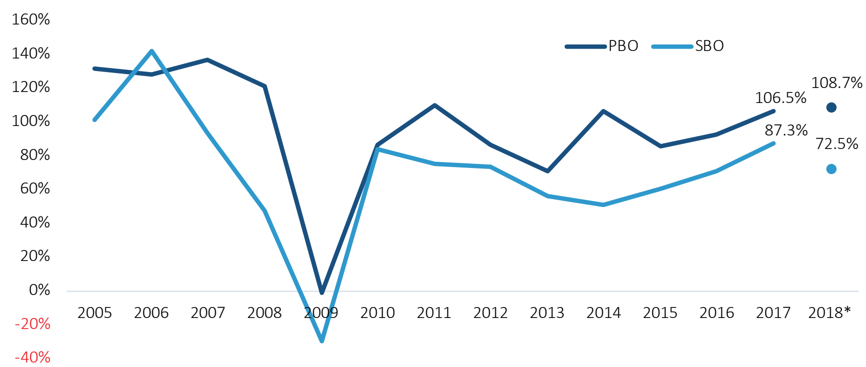


Source: PitchBook
*As of May 2018

Trash or treasure?

Gaining insight into deal structuring and investment theses is important, but at the end of the day, risk and returns are what really matter. While it is difficult to capture the full performance picture for many buyout deals, our data suggests that the outcomes for SBOs are comparable to PBOs. To approximate value creation, we examined portfolio companies' change in enterprise value during PE ownership. For this analysis, we looked only at companies that were exited via a sale (i.e. M&A, SBO, institutional buyout) to minimize valuation differences that arise in public offerings. It is worth reiterating here that companies acquired via SBO are more likely to be exited via another SBO, rather than to a strategic. Admittedly this methodology is less than perfect, as it does not account for dividend recapitalizations, changes in the capital structure and other pertinent points; however, it provides an approximation for value creation.

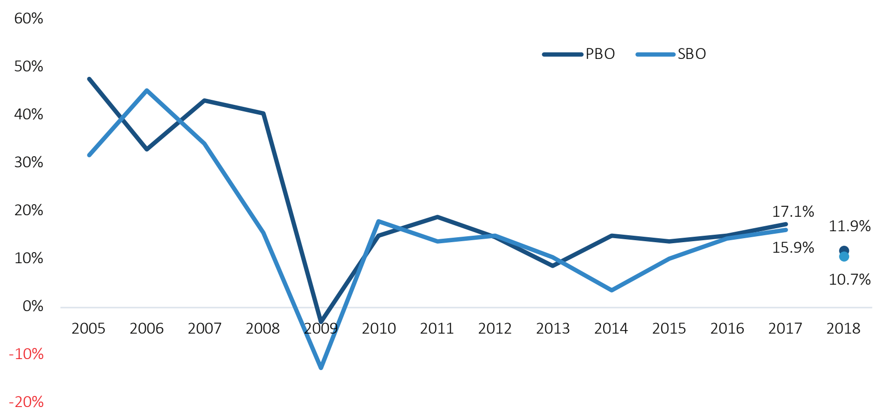
Global median % change in EV from entrance to exit



Source: PitchBook
*As of May 2018

Over the last several years, the median increase in enterprise value has consistently been 60–80% for companies acquired via SBO. While these figures lag the median enterprise value step-up of 85–110% observed in PBO deals, it's important to keep in mind that hold times for SBOs have been shorter too. To that end, when you look at the annualized increase in enterprise value, the discrepancy between PBOs and SBOs virtually disappears.

Global median annual % change in EV from entrance to exit



Source: PitchBook
*As of May 2018

Of course, boosting a company's enterprise value is not the only way for GPs to generate returns. To that end, we find that GPs are more likely to extract value via recapitalizations when a company is acquired via an SBO versus a PBO.

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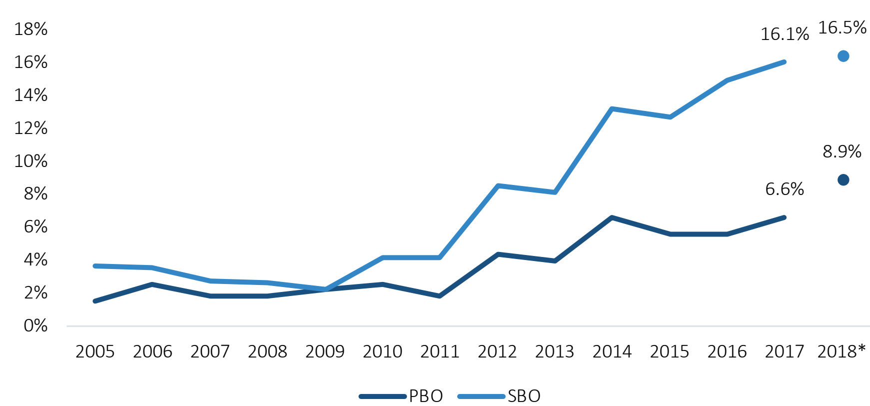
Recapitalizations are in some ways indicative of broader concerns that SBOs are subject to more downside risk because GPs may be incentivized to push the envelope to drive returns. While there are certainly examples of SBOs ending poorly, in our sample, the rate of bankruptcy among SBOs (8.9%) comes out slightly below that of PBOs (10.1%).

Global % of exits with at least one recap



Source: PitchBook
*As of May 2018

To be sure, each deal is unique, and the ultimate outcome is dependent on numerous variables outside of how the transaction was initially sourced. Our initial analysis, however, suggests some fundamental differences in how investors approach SBOs, particularly when the company has already been through an SBO. There is evidence that PE firms undertake more aggressive value creation plans when a company has already been through multiple rounds of PE ownership, but this does not seem to lead to longer hold times. GPs also seem keen to take money off the table earlier in SBOs, as it generally takes longer to reach a full exit, but this practice has not resulted in more left-tail outcomes such as bankruptcies. Going forward, we anticipate SBOs to continue playing an increasingly vital role in PE dealmaking, with the trend continuing to expand beyond traditional PE sectors into more niche areas.

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Note: Data was compiled throughout May 2018. Most data as of May 31, 2018.