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What determines the exit decision for leveraged buyouts? ☆

Tim Jenkinson [a,*], Miguel Sousa [b]

[a] Saïd Business School, University of Oxford and CEPR, United Kingdom
[b] School of Economics and Management, University of Porto and CEF.UP, Portugal

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ABSTRACT

How and when to exit portfolio company investments are critical choices facing private equity funds. In this paper we analyze 1022 European private equity exits, using information on fund and portfolio company characteristics, and on conditions in capital markets. For over 43% of the exits, private equity funds sold to each other and we analyze why such secondary buyouts have gained in popularity relative to IPOs and sales to corporate acquirers. We find that the exit route depends on various portfolio company characteristics, and that conditions in the debt and equity markets have a strong influence on exit choice. The existing literature has tended to portray the IPO is the "preferred" exit route. However, our analysis suggests this is mistaken: private equity funds take advantage of 'windows of opportunity', and the exit route that maximizes value varies with market conditions.

1. Introduction

Exiting portfolio company investments is one of the most critical choices faced by private equity funds. Yet little is known about the timing of exit decisions or the choice of the exit route – which are broadly IPO, sale to another company ("trade sale") or sale to another private equity fund ("secondary exit"). The aim of this paper is to fill this gap and provide insights into the timing of private equity exits, and the choices made by private equity firms.

Previous research has tended to focus on the IPO as an exit route (Lerner, 1994; Murray, 1994; Barry et al., 1990; Giot and Schwienbacher, 2007). However, IPOs are relatively uncommon, with the vast majority of private equity exits being trade or secondary sales. Furthermore, the recent growth of secondary buy-outs has generated considerable controversy. As we show, around 43% of all exits were secondary sales in recent years. Some commentators refer to these as "pass the parcel" deals, implying that the ultimate value of the company – once the music stops and the true value is revealed by a sale to someone other than another private equity fund – is very uncertain. Investors (the Limited Partners in the fund, or LPs) often complain about such deals. In particular, when an LP is an investor in both the selling and acquiring fund, they continue to hold a stake in the company, but have paid often significant transactions fees and, in some cases, will have crystalized a profit share (or "carried interest", which is typically 20% of the profits) for the exiting private equity manager (the General Partner, or GP).

Given the way private equity funds are incentivized, in particular the fact that they earn carried interest provided the fund beats a hurdle rate expressed in terms of the whole fund internal rate of return (IRR), the timing of the exit cannot be divorced from the route chosen. A rapid exit will boost the IRR, and so private equity funds will, to some extent, trade off the immediacy, and certainty, of an exit route with maximizing value. An important contribution of this paper is to analyze the time-to-exit dynamics, using a hazard function framework. Although much of the literature asserts that IPOs are associated with "successful" exits, they do not result in quick, or certain, proceeds for private equity funds, given the requirement for their stakes to be locked-up for at least 6 months, and the difficulty of disposing of significant stakes.[1] Secondary sales are relatively quick, the proceeds are certain and, unlike trade

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* Corresponding author.

[1] The financial performance of LBOs that return to public markets relative to conventional IPOs has been studied by Cao and Lerner (2009) and Cao (2011). The latter paper provides evidence that private equity funds sell-down their stakes in companies they take back to public markets surprisingly slowly. This confirms that an IPO is only, in itself, a partial exit, and the achievement of full exit can take several years in practice.

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sales where competitors often emerge as the most likely purchasers, they seldom involve regulatory issues. Consequently, secondary sales are often welcomed by LPs. The controversy regarding secondary transactions is, therefore, mainly focused on the *purchasing* GP. Why are they buying a company that has already been worked on actively by another GP for several years?[2]

To analyze these issues, the paper focuses on exits of European private equity leveraged buyouts (LBOs) between January 2000 and December 2014 using a very large (self-collected) sample of 1022 portfolio companies.[3] Previous studies as Sudarsanam (2005) studied the exit choice for 104 UK LBOs investments and found that operating performance, firm size, length of holding period and whether the firm belonged to the 'high-tech' industry were all significant determinants of the exit strategy. Wang (2012) also studies UK secondary exits. As Wang only has data on a relatively small number of companies she does not differentiate between IPOs and trade sales as alternative exit routes.[4] Using our much larger pan-European dataset we are able to identify the main factors that influence whether private equity funds choose to exit via IPO, trade sale, or a sale to another financial buyer. Cumming and MacIntosh (2003b), focus mainly on the determinants of a partial exit, as opposed to a full exit, within the full range of exit vehicles and found that the greater the degree of information asymmetry between the private equity firm and the buyer, the greater the likelihood of a partial exit and suggested that partial exits were used as a signal of a portfolio company's quality.

This paper considers three sets of factors – which are likely to interact – that could influence the timing of exit and the choice of exit route.

First, we investigate the impact of market conditions. Private equity firms want to achieve the best exit price possible and capital market conditions may create different 'windows of opportunity'. For instance, higher availability of funds in the loan market, a "cold" IPO market or large amounts of capital committed but not yet invested in the private equity industry may make secondary buy-outs the most profitable exit route. Consistent with this hypothesis, Axelson et al. (2013) find that a higher availability of debt (measured by leverage multiples – Total Debt/EBITDA[5] – used in leverage buyouts) has a strong impact on the prices of deals as private equity firms borrow as much as they can for each deal. Shivdasani and Wang (2011) also document the important impact of credit markets and securitization, and show that the LBO boom in the years before the financial crisis was largely fuelled by cheap debt with few covenants.[6] Therefore favorable debt market conditions may increase the likelihood of a secondary buy-out transaction.

On the equity side, the well-documented cycles in the number of initial public offerings (and in the initial returns of such IPOs) also suggest the existence of windows of opportunity in the public equity markets.[7] For instance, whilst relatively few private equity exits to public markets were observed in the years following the financial crisis, there was a flurry of private equity-backed IPOs during 2014.

The second set of factors we consider relate to the private equity fund structure. As noted earlier, private equity investing is generally carried out through partnerships/funds that have a contractually finite life, normally ten years, which can be extended only with the consent of the LPs. Moreover, private equity firms set up new funds approximately every three to five years and a good track record for timely exits as well as past performance are crucial to enhancing a firm's reputation and future fundraising (Phalippou (2008)). Therefore, when a private equity fund is near the end of its contractual life, the GP faces pressure to realize investments.[8] Consistent with this observation, Masulis and Nahata (2009) found in the case of trade sales that the returns of the purchasing company are, on average, higher when the selling private equity fund is closer to maturity. Cumming and MacIntosh (2003a) conjecture that as the fund approaches its maturity, there may be portfolio companies that are not yet ready for a public offering or a strategic sale, which may make a secondary sale attractive, insofar as it can avoid having to request an extension on the life fund.

More benignly, GPs have different specializations. Some are focused on earlier stages of investment and others on expansion or late-stage investments, and so the recent wave of secondary buy-outs may have occurred because portfolio companies matured and grew and so were sold to other private equity firms that focus on such companies.[9] In this case we might expect the two private equity firms involved in a secondary transaction should differ in terms of their experience, specialization, etc. Therefore, these various characteristics such as the holding period of the investment, how close the fund is to maturity, and the experience or specialization of the private equity fund may influence exit choice.

The final set of factors we consider relate to the portfolio company. It may be that some companies are more suited to particular exit routes. For instance, companies which can operate with high levels of debt – due to stable cash-flows or low investment needs – may be particularly suitable for continued private equity ownership, and so more likely to realize a secondary exit. And, emphasizing the point that these sets of factors can interact, the probability of a secondary exit for such a company would be expected to increase further when debt market conditions are favorable. Or it could be that firms have different monitoring needs, as suggested by Bienz and Leite (2008). In their model highly profitable companies – which require less monitoring – are more likely to be exited through an IPO whereas less profitable companies are exited via a trade sale. We explore whether such firm characteristics can explain exit choices.

Our main results are as follows. First, our analysis suggests that capital market conditions are the most important determinant of the exit route. Private equity funds exploit the windows of opportunity that open at different times. For instance, in 2006–07 the extraordinary conditions in the credit market made possible the use of higher levels of debt in European buy-outs. Furthermore, the huge amount of capital that was committed to private equity before the financial crisis led to a shift in demand. Together these factors made private equity firms willing to pay more for portfolio companies, which increased their bargaining power relative to corporate acquirers, and resulted in a high proportion of secondary sales.

Second, we find an important role for portfolio company characteristics. In particular, as would be expected, secondary buy-outs are more likely when the portfolio company's characteristics

[2] Achleitner and Figge (2014) and Bonini (2015) have analyzed the sources of value creation for secondary buyouts. Guo et al. (2011) and Harford and Kolasinski (2013) study value creation in buyouts more generally, irrespective of the chosen exit route. A summary of evidence regarding financial performance of buyouts in general can be found in Cumming et al. (2007).

[3] We focus on buyouts as entry and exit are much easier to observe compared with venture capital deals where there can be multiple rounds of investing and divesting.

[4] Wang (2012) only identifies 5 IPOs in her UK sample; we have 142 in our broader European sample.

[5] EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization.

[6] Also, as noted by Groh and Gottschalg (2011), buyout transactions tend to happen in lower risk industries, and so the availability of leverage becomes important to generate higher returns (even if not on a risk-adjusted basis).

[7] See for instance Ibbotson and Jaffe (1975), Ritter (1984) and Lowry and Schwert (2002).

[8] Arcot et al. (2015) use an exit in year 9 or 10 of the life of the private equity fund as a sign that the GP is "under pressure".

[9] "If you have different funds with different strategies, it's natural that firms will want to buy and sell to each other" says Ross Marshall of Dunedin Capital Partners in September 2001 and "[P]rivate equity bosses say secondary buy-outs can be a way to take a company to a new level" in Financial Times (4th November 2010).