Private Equity Exits

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Divestment Process Management for Leveraged Buyouts

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Preface

In line with strong growth in Europe over the past years, private equity as a form of financial intermediation has become a focus area for academic research. However, only few scientific studies to date concentrate on the divestment stage of portfolio companies, the so-called 'exit' processes. My interest in this field has been stimulated through my professional experience as an investment banker advising private equity clients in Europe, recognising a lack of structured and pro-active approaches towards divestment of portfolio firms.

I am indebted to a number of people and institutions that contributed to the success of this project. First and foremost, I would like to offer many thanks to my academic supervisor Prof. Dr. Andreas Grünbichler for his commitment to this project as well as his responsiveness, instrumental guidance, and constructive feedback. I would also like to express great appreciation to my second academic supervisor Prof. Dr. Martin Hilb, for his support and valued input particularly in the area of corporate governance. Moreover, I owe thanks to Prof. Dr. Josh Lerner for his interest in this project and guidance offered during my research visit at the Harvard Business School.

The essential core of this work relies upon detailed survey and interview feedback from almost 60 leading private equity firms operating in the European buyout market. I would like to thank all private equity professionals and institutions for having participated in this study and for their interest in supporting academic research in this field. Furthermore, I am grateful to Georges Noël from the European Private Equity and Venture Capital Association for supporting this study and his helpful input on the survey procedures. I am also grateful to Dr. Volker Kraft for his advice on designing a survey targeting private equity firms and to my friend and colleague Dr. Nicolaus Loos for his valuable recommendations in pursuing such a project. Moreover, special thanks are directed to my employer, JPMorgan, for having supported this project and for accommodating my commitment to these studies.

I owe deep gratitude to my wife Bianca for being a strong supporter and an inspiration throughout the project. Last but not least, I express great thanks to my parents for their continuous backing of my studies and for having greatly facilitated the freedom in pursuing my interests throughout my life.

Stefan Povaly London, January 2007

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1 Introduction

In parallel with tremendous growth[1], particularly over the past 15 years, private equity as a form of financial intermediation has become a focus area for academic research. The term '*private equity*' in its widest sense captures investments in companies that are not publicly quoted.[2] Harvard professors GOMPERS and LERNER (2001, 2004) point out that despite the strong growth of the private equity industry and an increasing degree of academic attention, many questions about its functionings and features remain unanswered. The fact that private equity firms tend to avoid publicity about the transaction details and returns of their investments has been a barrier to extensive quantitative research. However, literature to date has elaborated in detail on aspects such as fundraising, contracts between private equity funds and investors, relationships between private equity providers and acquired companies, value creation and valuation, performance measures, to list only a few.

A key characteristic of private equity finance is that investors hold their investments only for a limited period of time. The common structure of private equity firms as funds with pre-determined lifespans of usually ten years requires a timely unwinding of the positions taken (i.e., GOMPERS and LERNER 1999a, 2004, NEUS and WALZ 2004).

There are several contributions to the analysis of options available to private equity firms when intending to sell or at least reduce exposure to an investment (a procedure usually referred to as '*exit*', '*divestment*' or '*dis-investment*'). LERNER and HARDYMON (2002, p. 7) underline that successful exits are critical for private equity funds to ensuring attractive returns for investors and also to raising additional capital. NEUS and WALZ (2004) enforce that exit processes are one of the most crucial determinants of a private equity investor's success. However, as CUMMING and MACINTOSH (2003a, pp. 512-513) acknowledge, albeit the importance to the industry, there are very few publications focusing on the exit process and related

1 Details regarding the history and evolution of the private equity market are setout in section 2.1.2.

2 For detailed definitions of the private equity industry, please refer to section 2.1.

decisions going beyond an analysis of individual exit options such as a sale of a portfolio company to a trade competitor, another private equity investor or alternatively pursuing a public stock exchange listing.[3]

Furthermore, the majority of studies on private equity exits to date concentrate geographically on the United States as well as on the divestment actions by venture capital firms undertaking investments in firms that are early on in their development process, requiring capital for initial product development or expansion. The analysis of exit processes in relation to European portfolio companies in general as well as investments in mature and often larger firms structured as leveraged buyouts[4] in particular has not received great academic attention.

Given the substantial growth and the rapid evolution of the private equity market, an analysis of exit processes has to take into account several trends and circumstances altering the industry environment. Among trends fuelling competition in the private equity market, the emergence of hedge funds as direct competitors for private equity assets requires particular consideration. While recent articles proclaim a '*convergence*' of hedge funds and private equity, some authors view hedge funds as having made more of an impact on the private equity market than vice versa (i.e., DEWSON 2005, pp. 14-15).

1.1 Framework and intent of the work

The objective of this book is to contribute to the understanding of decisions, styles and preferences in relation to exit processes, concentrating on private equity investments in mid-sized and large European companies, acquired through leveraged buyouts[5]. Smaller buyouts are not considered

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3 Important examples of studies examining divestment routes have been contributed by NEUS and WALZ (2004), LERNER and SCHOAR (2004), KAPLAN and STROEMBERG (2004), CUMMING and MACINTOSH (2003a, 2003b, 2001), GOMPERS and LERNER (2003, 2001), BASCHA and WALZ (2001), or LIN and SMITH (1998).

4 Please refer to section 2.2 for a detailed definition and description of leveraged buyouts.

5 The research focus of this study is limited to buyout firms undertaking mid-sized and large investments defined with a minimum transaction value of €100 million at the time of exit. While NVCA (2005a) classifies US mid-sized buyouts at a minimum transaction value of US$250 million, the lower €100 mil-

in the analysis, primarily as these transactions typically have a limited scope of divestment alternatives. Furthermore, in the author's experience smaller transactions do not obtain sufficient and reliable coverage in transaction databases that represent an important information source for the empirical part supporting this study. The market for European buyout investments[6] sets the framework for the analysis, taking a pan-European rather than a national perspective. This reflects that, although transaction details have to be structured differently across European jurisdictions, buyout funds are typically managed and raised on pan-European basis.[7] Recent studies also advocate the application of a pan-European lens when examining buyout investment behaviour, including divestments (i.e., BOTAZZI, DA RIN and HELLMANN 2004, HUDSON 2005, pp. 5-11, EVCA 2005c, pp. 29-36).

The scope of the analysis is geographically limited to Europe[8] and does, in contrast to similar studies (i.e., SCHWIENBACHER 2002), not extend to a more global perspective, given that Europe provides an increasingly harmonised platform for buyout investments (BLAKE and WITNEY 2005, pp. 13-15) with distinct structural parameters compared to other regions such as the United States or Asian economies. Key examples are differences in the evolution and state of regional capital markets and interest rate environments, which are of fundamental importance in a buyout exit context. Due to these essential distinctions, the narrowed regional scope of the analysis is viewed as appropriate and even necessary.

A focus of the analysis is set on decision determinants regarding exit processes, critically evaluating concepts and theories established and proven in similar studies. These concepts and theories suggest the relevance of certain factors which will be assessed in the context of buyout exits. Additionally, relationships between buyout investors' characteristics and their exit behaviour are being examined.

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lion threshold is not uncommon for the smaller European private equity market (i.e., EVCA 1998).

6 The definition encompasses financial investors conducting leveraged buyouts involving European target companies, and thus also captures investor firms not originating from Europe.

7 Please refer to section 2.2.4.2 for a discussion of the pan-European leveraged buyout market that forms the relevant research universe for the analysis throughout this work.

8 Covering European Union member states and all other Western and Northern European countries.

The objective of this work is to provide answers to a number of research questions, each of which concentrates on the exit process management of buyout investors:

1. Which factors are the key decision drivers regarding the timing of exits?
2. Which factors are the key decision drivers regarding the choice of exit route?
3. Which buyout investor characteristics explain differences in exit preferences and exit process management? What impact do corporate governance styles and involvement of portfolio companies' executive management have on exit decisions?
4. Why and under which circumstances do buyout investors pursue more than one exit route in parallel and what are the downsides of such processes?
5. What impact did the change in the private equity environment over the past years including the entry of hedge funds in this market have on the exit behaviour of buyout investors?
6. How have the trends in buyout exits related to the evolution of buyout funds performance?

The author has identified three niches of contribution of this work to current literature on private equity exits:

1. Focus on European leveraged buyouts

Existing studies discussing selected aspects of private equity exits focus almost exclusively on the Northern American market (i.e., CUMMING and MACINTOSH 2001, 2003a, 2003b, NAHATA 2004). Furthermore, these studies concentrate either on venture capital investments in relation to early stage investments or do not distinguish between types of private equity investors (i.e., SCHWIENBACHER 2002). The author could not identify a study capturing European portfolio firms, let alone research examining buyout investors, which constitute the research universe for this work.

2. Contrasting types of private equity investors in exit processes

Through the analysis of exit behaviour and preferences of a diverse set of investors, the study seeks to examine differences and commonalities. Most studies that are empirically exploring exit aspects ultimately do not discuss differences in investment behaviour, preferences and priorities of large versus smaller or young versus established private equity firms (i.e., SCHWIENBACHER 2002, CUMMING and MACINTOSH 2001, 2003a, 2003b) and do not include aspects of managerial involvement and corporate governance styles of investors in the analysis.[9]

Furthermore, the study will test theories and concepts that have been empirically tested and confirmed in the context of early stage venture capital exits and will demonstrate that some of these concepts seem valid for the assessment of buyout investors' exit actions while others seem less appropriate.[10] On the basis of the empirical analysis underlying this study, the author advocates a more serious separation between venture capital investors and later-stage buyout investors in private equity research. Although studies such as GOMPERS (1996) and GOMPERS and LERNER (2004) emphasise differences between venture capital and buyout firms, several research contributions on exits lump these private equity segments together in the datasets forming the basis for analysis (i.e., SCHWIENBACHER 2002, NAHATA 2004). The scarcity of available data appears to be a reason for samples comprising various types of private equity investors. The analysis in this book strictly concentrates on buyout investments, aiming to support the validity of its findings relevant to this particular private equity investor segment.

Of particular interest in this context is an analysis of differences in the exit behaviour of '*traditional*' private equity firms versus hedge funds that directly invest in private equity assets. This discussion will be underpinned by the question of whether the '*traditional*' notion of longer-term '*value-creation*' in buyout investments is still pre-dominant or is being phased out in favour of a more aggressive short-term '*value-finding*' investment style practiced by hedge funds.

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9 The importance of taking the characteristics of private equity firms into account when examining investment decision determinants is stressed for example by GOMPERS (1996), LIN and SMITH (1998), GOMPERS and LERNER (1999a, 2004) and NAHATA (2004).

10 While a number of decision parameters suggested by theories and established concepts may be relevant for all private equity segments, the weight of importance might be different between distinct private equity segments. A part of the empirical analysis underlying this study is designed to obtain rankings for determinants in order to assess and compare the relative weights of these factors.

Summarising this second point, the author believes that differences in the characteristics of private equity firms have been largely neglected in the analysis of exits. The research work underlying this book attempts particularly to take buyout firms' investor characteristics into account and differentiate between investor types.

3. Exit preferences and process management

It is a widely believed and accepted proposition in private equity literature that a public listing of a private equity portfolio company is the ultimate and most successful form of exit (i.e., GOMPERS 1996, GOMPERS and LERNER 1999a, 2001, 2004, NEUS and WALZ 2004). However, as RELANDER, SYRJANEN and MIETTINEN (1994) and WRIGHT and ROBBIE (1998, p. 551) demonstrate for European venture capital firms, public offerings are not the preferred divestment route. Given the less liquid European capital markets for high growth companies compared to the US, European venture capitalists have historically favoured a sale to competitor companies.[11] The empirical part of this work will report on the exit route and process preferences of buyout investors active in Europe, which have not been discussed in academic literature to date.

Moreover, the management of exit processes with regard to the execution of either a single divestment option or two or more exit alternatives in parallel[12] has not obtained academic attention in a European buyout context so far. This book seeks to contribute to the understanding of why and in which circumstances buyout firms pursue processes entailing more than one exit route. The analysis will also attempt to critically evaluate such exit procedures.

This research aims to complement the still thin layer of academic literature on private equity exits, particularly on buyout investments. Moreover, this work is also addressed to practitioners involved in buyout exit processes. Findings might be of interest to investment bankers mandated to advise private equity houses in divestment processes. Having an independent perspective on the buyout industry's priorities and preferences regarding exits as well as on its reaction towards competitive '*multi-track*' sale procedures might be useful to anticipate clients' needs and support pro-

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[11] EVCA (2005, p. 2) also reports that based on a survey among all types of private equity investors, trade sales have been the preferred type of exit.

[12] These divestment processes are frequently called 'dual-track' or 'multi-track' exit processes.

posed exit strategies. In addition, a clearer understanding of how investor characteristics impact exit behaviour could be beneficial when analysing buyout firms' portfolios in the pitching process for exit advisory mandates. Private equity firms might look at the findings to benchmark their exit process management to an industry perspective. The author also sees the potential value of the findings for any party interested in acquiring a portfolio company from a buyout investor, be it a competitor firm, another private equity investor or a hedge fund. Anticipating and understanding the needs and priorities of the selling party in a process can provide a considerable advantage in negotiations.[13]

This work highlights the growing need for pro-active as well as thoroughly planned divestment strategies, efficient executions, and the importance of paying attention also to other stakeholders' interests. This work is designed to serve as a compendium of current scientific knowledge on this topic.

1.2 Research approach

1.2.1 Research design framework

Taking into account the scope of the research questions to be addressed, the study involves an empirical analysis making use of both qualitative and quantitative data collection methods, in line with MILES and HUBERMAN (1994), who argue that a linkage of qualitative and quantitative data is beneficial, particularly for complex research objectives.[14] The research design is in line with other recent studies in this field[15], whereby mostly surveys have been conducted to collect the bulk of data, which form the base for statistical analysis.

The following exhibit sets out a schematic illustrating the applied research design, whereby a survey addressing buyout investors as well as database research represent the core data collection tools in stage two,

13 AIELLO and WATKINS (2000, pp. 100-107) provide a helpful guideline for the preparation of successful acquisition negotiations, supporting this argument.

14 RAGIN (2000, pp. 21-42) suggests that the benefit of a combination of both data types is to strike a balance between the complexity of qualitative analyses and the generality of findings from quantitative analyses.

15 For example: SCHWIENBACHER (2002) and CUMMING and MACINTOSH (2001, 2003a, 2003b).

which are supported by a qualitative data collection in step one. Expert interviews in step one help to identify and explore the parameters and relationships necessary to construct preliminary hypotheses and develop the survey questionnaire for step two. Lastly, feedback obtained in expert interviews is used to validate and deepen obtained findings.

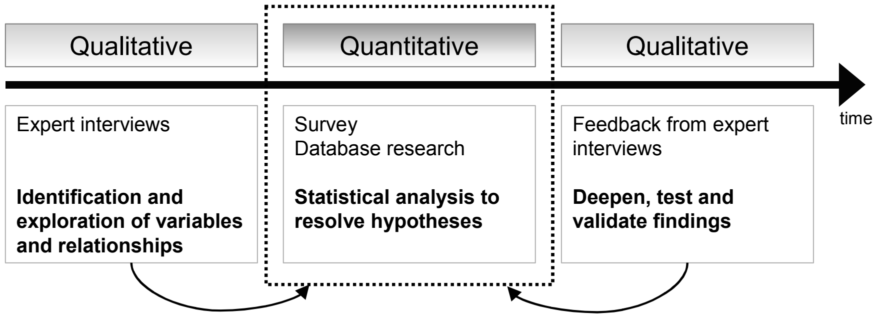

Exhibit 1. Methodological overview of the research project. Source: Own schematic.

The research design follows the principles of '*triangulation*'[16]. As SCANDURA and WILLIAMS (2000, pp. 1249-1250) summarise, triangulation reduces trade-offs of individual research strategies and can strengthen the validity of a study.[17]

This research design is very similar to the methodological approach applied by KRAFT (2001), who analysed turnaround investments by private equity investors.[18]

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[16] The term '*triangulation*' stems from navigation and military strategy where it means that several reference points are used to determine an object's exact location (SCANDURA and WILLIAMS 2000, p. 1249).

[17] The outlined research process supports triangulation with respect to data collection as qualitative interview data as well as quantitative survey questionnaire data are collected. In addition, triangulation with respect to the research strategy can be considered, as statistical examinations on a larger dataset which facilitate a generalisation of findings, and also an analysis of investor specific in-depth interview information have been performed.

[18] KRAFT (2001) also used structured interviews to identify key parameters and conducted a survey that represented the core data source for subsequent statistical analysis.

1.2.2 Research approach and procedure

As a first step in the research process, the author arranged 15 structured interviews with mostly senior representatives from buyout investors operating in Europe[19]. These expert interviews were conducted over the period from February to April 2005. The core objective of this first research step has been to identify and confirm key variables and also to support the creation of a survey questionnaire applied in the second step. Initial hypotheses, developed on the basis of established theories and concepts proven in other private equity studies, were refined and adapted based on expert feedback, without leaving the ground of an academic, theoretical foundation. Arranging interviews, the sampling strategy has considered capturing both dynamics at investors focusing on the largest transactions in Europe as well as investor firms focusing on smaller transactions, which nevertheless still meet the specified critical size requirement. Decision processes at these private equity firms were expected to show similar overall dynamics but potentially placing different weight on various factors.

With regard to the style of the interviews, a structured guideline has been applied to direct the discussion, which followed the flow of preliminary research questions and hypotheses.[20] As the private equity industry tends to be very secretive and sensitive about leaking information, the interviews were not recorded in any form.[21]

Building upon the insights obtained through structured interviews in the first stage, the author has developed a survey questionnaire, representing the core data collection method for the empirical analysis. The survey design process lasted three months from April to June 2005 and benefited from input provided by academic researchers, several private

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[19] A list of interview partners is provided as an appendix.

[20] Principles recommended by MASON (1996, p. 42-47) were considered. She stresses the importance of prior preparation of the interview with regard to having a clear strategy as to what level of information is required already in light of subsequent data analysis.

[21] HART (1991, pp. 192-195) discusses the steps in an interview process in detail and also highlights the obvious fact that tape recordings can rather harm the quality of information received if the respondent is expected to provide insights into facts that otherwise are not disclosed.

equity firms, and the '*European Private Equity and Venture Capital Association*' (EVCA), which has been supporting the survey.[22]

Before launching the survey at the end of June 2005, a pilot-test[23] with 5 buyout investors was conducted in order to ensure the clarity and practicality of the questionnaire.[24] Feedback from pre-tests resulted in a number of minor modifications of the survey before disseminating the questionnaire to the identified universe in the form of an internet-based survey.[25]

The table in the exhibit below highlights that 316 buyout investors have been identified through '*Mergermarket*' and '*Thomson VentureXpert*'. The search was limited to buyout investors active in Europe acquiring companies with a minimum transaction value of €50 million. Removing private equity funds with a pure real estate focus, funds that have not performed exits exceeding €100 million transaction value in the period from January 1998 to June 2005, as well as subsidiaries of other funds to avoid double counts leads to a total of 257 investors. When confirming and verifying contact details for each firm, the author had to remove 42 firms, for which no contact details could be obtained, resulting in an addressable universe of 215 buyout firms.

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[22] Similar surveys have been conducted successfully with private equity firms both in Europe (BOTTAZZI and DA RIN 2002, BOTTAZZI, DA RIN and HELLMANN 2004) as well as the United States (CUMMING and MACINTOSH 2001, 2003a, 2003b, KRAFT 2001).

[23] ROSSI, WRIGHT and ANDERSON (1983, pp. 225-227) discuss the importance of pre-tests before launching surveys, setting out helpful guidelines to perform pre-tests.

[24] KENT (2001, p. 8) outlines criteria for successful survey questions: "*clear, understandable, unambiguous, specific, answerable/ testable, interconnected, relevant to the research problem and the research orientation.*"

[25] Exploring contemporary issues with internet-based survey questionnaires, TARNAI and MOORE (2004, pp. 323-325) highlight a list of potential pitfalls and flaws that require consideration and ought to be avoided when designing computer-based questionnaires. HANSEN and COUPER (2004, pp. 345-349) also stress the importance of extensive usability tests before starting computer based surveys, in order to ensure that there are no areas of technical errors (such as screen and system compatibility) that could also lead to low response rates as well as to ensure the high user friendliness and simplicity to answer questions and complete the questionnaire.

Relevant Private Equity Firm Universe	
Total firms identified by MERGERMARKET database European buyouts, >€50 mm at acquisition	302
Additional firms through Thomson VentureXpert database	14
Total universe of buyout investors	**316**
Removal of real estate oriented funds	9
Removal of funds without exit transactions exceeding >€100 mm	31
Removal of subsiaries of other funds (double counts)	19
Sub-Total	**257**
Removal of firms where no working contacts could be obtained	42
Total addressable universe	**215**

Exhibit 2. Analysis of addressable universe for survey. Source: Own analysis.

The online distribution and accessibility of the survey allowed for respondents to be tracked, permitting the matching of information about their respective firms available in databases with questionnaire responses. Two months following the launch of the survey, after two rounds of reminders to those investors contacted, 56 buyout firms responded, returning completed questionnaires. This equals a response rate of 26.0%, which is slightly better than in comparable studies[26]. The higher response rate could be potentially explained by the fact that each contact had been verified and confirmed prior to distributing questionnaires, while other surveys have often been circulated relying purely on database information.

Worth noting is that among the list of the top 50 buyout investors, 17 participated in the survey, resulting in a response rate of 34%, while out of the top 100 buyout investors, 27 returned a completed survey.[27]

[26] KRAFT (2001) received 46 responses at a response rate of 23%, SCHWIENBACHER (2002) obtained 66 European responses at a response rate of 18%, BOTTAZZI, DA RIN and HELLMANN (2004) received 150 responses at a response rate of 15%.

[27] Top 50 and Top 100 ranking of relevant buyout investors is based upon MERGERMARKET (2005). Ranking according to realised exit volumes by investor.

Response rate analysis	
Firms responded	56
Response rate	*26.0%*
Responses in Top 50 List	17
Response rate Top 50	*34.0%*
Responses in Top 100 List	27
Response rate Top 100	*27.0%*

Exhibit 3. Response rate analysis. Source: Own analysis.

The sample of participating firms obtained is diverse with regard to size measured in terms of capital under management, number of partners and employees, number of portfolio companies, as well as age.[28] Furthermore, 6 hedge funds active in the European buyout segment participated in the survey.[29]

1.3 Structure outline

This work is structured into 6 sections. Following this introduction part, section 2 sets out the background for this work, providing definitions, descriptions and market details for the overall private equity market, the market for leveraged buyouts as well as an introduction on divestments. Subsequently, section 3 establishes a theoretical foundation for the research project and lays out a detailed review of relevant studies. This part concludes with a tabular summary of the studies most relevant to research on exit processes.

Building upon the previous introductory parts, section 4 explores each step of typical exit processes and provides a detailed analysis and assessment of different divestment options. Section 5 presents the empirical analysis underpinning this work. Lastly, section 6 offers conclusions and an outlook, discusses the relevance of the obtained findings and highlights several potential areas for related future research. The following exhibit illustrates the structure of this work.

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[28] Details regarding the characteristics of the sample will be discussed in the empirical analysis section 5.

[29] A list of participating firms is provided as an appendix.

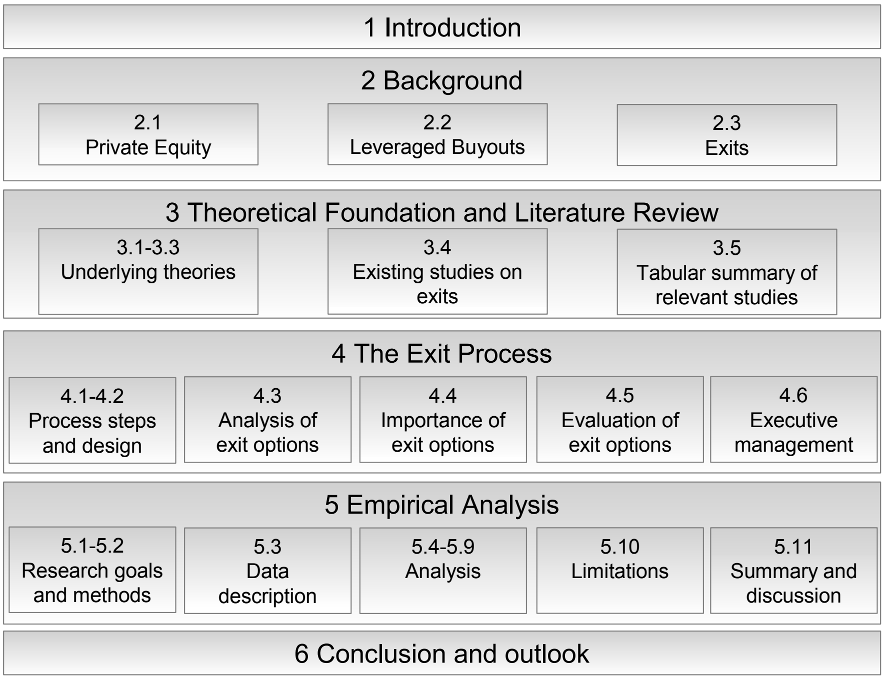

Exhibit 4. Structure overview of this work. Source: Own illustration.

2 Background

2.1 Private equity

2.1.1 Definition

LERNER (1999) defines private equity organisations as partnerships specialising in venture capital, leveraged buyouts, mezzanine investments (which combine debt and equity contract characteristics), build-ups, distressed debt, and other related investments. Typically, the venture capital and leveraged buyout aspects are considered to represent the core nucleus of private equity activities. Private equity and venture capital firms are frequently labelled as '*financial sponsors*'. In contrast to public equity, private equity deals in general with companies that are not quoted on a public stock exchange.

In practitioner terms '*venture capital*' is usually closely associated with the financing of young, newly founded companies, so-called '*start-ups*' as well as growth financings for firms that are still in early stages of their corporate development. GOMPERS and LERNER (2001, p.146) define the core part of venture capital as "*independent, professionally managed, dedicated pools of capital that focus on equity or equity-linked investments in privately held, high growth companies*". On the contrary, '*private equity*' as a term is often associated with equity investments in more established companies, mostly structured in the form of leveraged buyouts.

FENN, LIANG and PROWSE (1995, p. 2) link the definition of private equity to the core activity of typical financial sponsors, acquiring large ownership stakes and taking an active role in monitoring and advising portfolio companies. The term '*private equity market*' in a broader sense, however, captures more than the market relevant for this study namely the professional management of investments in unregistered securities of private and to a certain extent also public firms, which is often referred to as '*organised*' private equity market. In principle, private equity also encompasses the market for '*angel capital*'[30] as well as the so-called '*informal*' market[31] for private equity, both of which are not relevant for this study.

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[30] The market for angel capital represents investments in small, closely held companies by wealthy individuals, many of whom have experience in operating