PitchBook

Measuring SBOs' Effect on Fund Performance

PitchBook is a Morningstar company. Comprehensive, accurate and hard-to-find data for professionals doing business in the private markets.

Credits & Contact

Analysts

DYLAN E. COX Senior Analyst, PE
dylan.cox@pitchbook.com
DARREN KLEES Data Analyst

Contact PitchBook

RESEARCH
reports@pitchbook.com

Contents

Key takeaways

- While some previous research has found that secondary buyouts (SBOs) have an adverse effect on fund performance, **we find no clear difference in performance between SBO-oriented funds and other buyout funds**. A sample of funds that more often sources deals via SBO performed on par with the PitchBook Benchmarks based on measures of both cash multiples and IRR.
- On a total value to paid-in (TVPI) basis, **27% of SBO funds were in the top quartile of their peer groups in PitchBook Benchmarks,** slightly better than would be expected from a random selection; **however, 54% of SBO funds ended up in the bottom half of their respective peer group.**
- On an internal rate of return (IRR) basis, **slightly more than half (56%) of SBO funds in our sample finished in the bottom half of their peer group. However, a full 25% finished in the top quartile,** as would be expected from any given fund from PitchBook Benchmarks.

Published on October 16, 2018

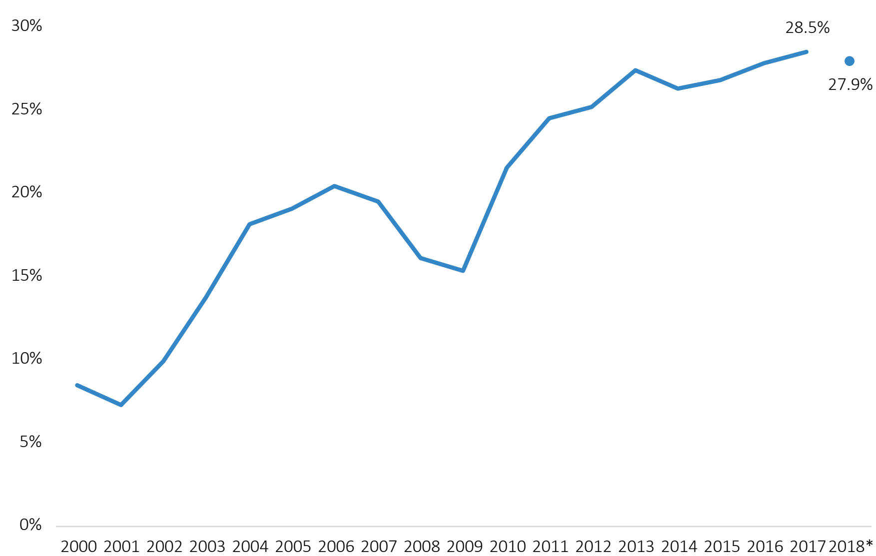
How we got here

SBOs, in which one PE sponsor buys a company from another, have become an increasingly common phenomenon in private markets. In a prior analyst note on the subject, we established the following key points:

- SBOs are now an integral deal sourcing channel. SBOs currently account for more than one-quarter of non-add-on buyout deals, up from 15% in 2008.
- SBOs often require more operational work, but that does not mean longer holding 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 holding 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.

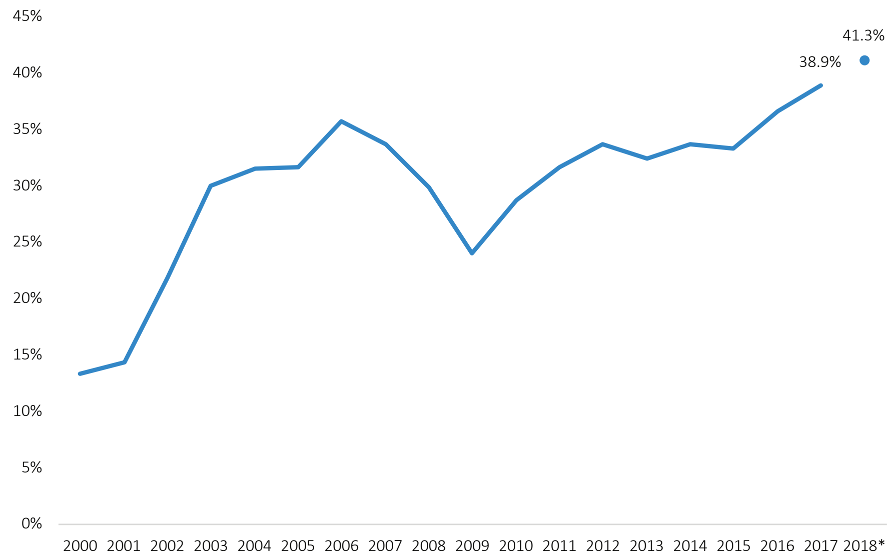
SBOs have long been maligned for a variety of reasons. Some limited partners (LPs) worry that the increased frequency of SBOs may lead to situations in which they are effectively selling portfolio companies to themselves (because they may have an interest in funds on either side of a deal), paying transaction fees along the way. Another common criticism is that all the low-hanging fruit is picked by the first round of PE ownership, leaving little room for operational improvement in an SBO. However, GPs that source deals via SBO often counter that they have distinct expertise—from sector- or region-specific knowledge to

SBOs as proportion of global non-add-on LBOs



Source: PitchBook
*As of September 17, 2018

SBOs as proportion of global PE exits



Source: PitchBook
*As of September 17, 2018

an aptitude for expanding domestic companies internationally—that allows them to add value even after a portfolio company has lived through one or more financial sponsors' holding periods.

Previous research has been split on the performance of SBOs compared to traditional buyouts. One study found that "returns to secondary PE investors are positive but significantly lower than those of first round buyers."[1] A separate whitepaper asserted that "when the buyer and seller have complementary skillsets, SBOs generate significantly higher returns and outperform other buyouts."[2] However, the authors also point to nuanced evidence surrounding SBOs' effect on fund performance more broadly.

While the existing SBO data is inconclusive, GPs have been increasingly willing to source for each other—even when the company has already been through multiple owners. One example of SBO activity over the years is that of Gala Coral Group, an operator of casinos and bingo clubs in the UK and Italy. Before being acquired by a competitor in 2016, Gala Coral had completed no fewer than five add-on acquisitions under four different groups of PE owners, exemplifying a few trends found in our previous note on SBOs.

Due to the growing popularity of SBOs and potential effect on deal structuring, this note examines how they may affect PE fund performance.

1: "Secondary Buyouts: Operating Performance and Investment Determinants," Financial Management, Stefano Bonini, September 21, 2014
2: "On Secondary Buyouts," Journal of Financial Economics, Francois Degeorge, Jens Martin & Ludovic Phalippou, June 16, 2015

Methodology

Similar to the methodology employed in our report examining add-ons' effect on fund performance, we assess SBOs' effect on fund performance by comparing a select group of SBO-oriented funds to the broader PitchBook Benchmarks. We start by ranking firms in the PitchBook database based on their propensity to source transactions via SBO. Using only firms for which we have sufficient performance data (see inclusion criteria in PitchBook Benchmarks) and have also completed at least 10 buyouts since 2000, we created a sample of 100 SBO-oriented buyout funds, representing 10% of the PE funds in PitchBook Benchmarks. In the sample, fund managers source buyouts via SBO between 27.8% and 58.3% of the time. We'll refer to this sample simply as "SBO funds" hereafter.

SBO funds have a median fund size of $1.03 billion, versus a median size of $810 million for PitchBook Benchmarks. Both groups are about the same age, with a median vintage year of 2009. Lastly, SBO funds in our sample are more often managed by firms based in Europe as opposed to Asia or North America.

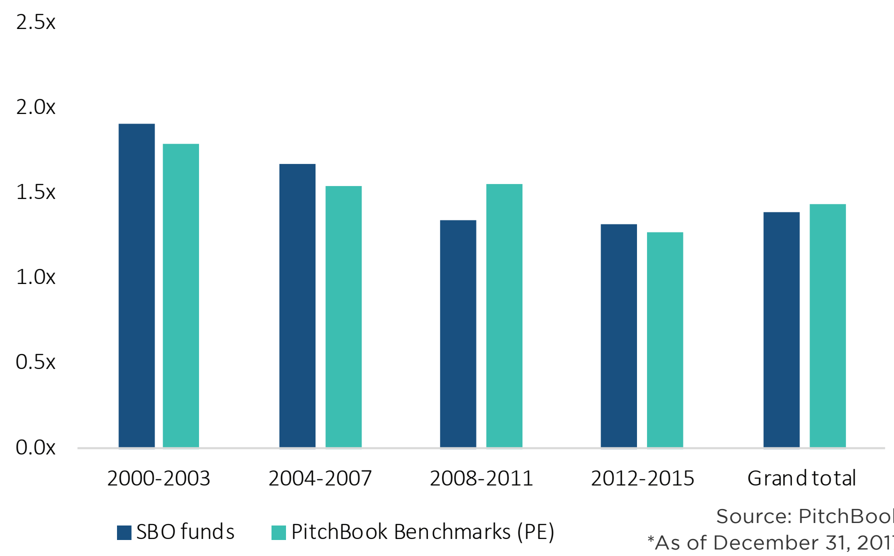
Select firms from sample of SBO funds

LNK Partners
Lion Capital
Groupe Alpha
One Rock Capital Partners
CapVest Partners
Kainos Capital
Ares Private Equity Group
Hampshire Equity Partners
Stirling Square Capital Partners
Chequers Capital

Benchmarking performance

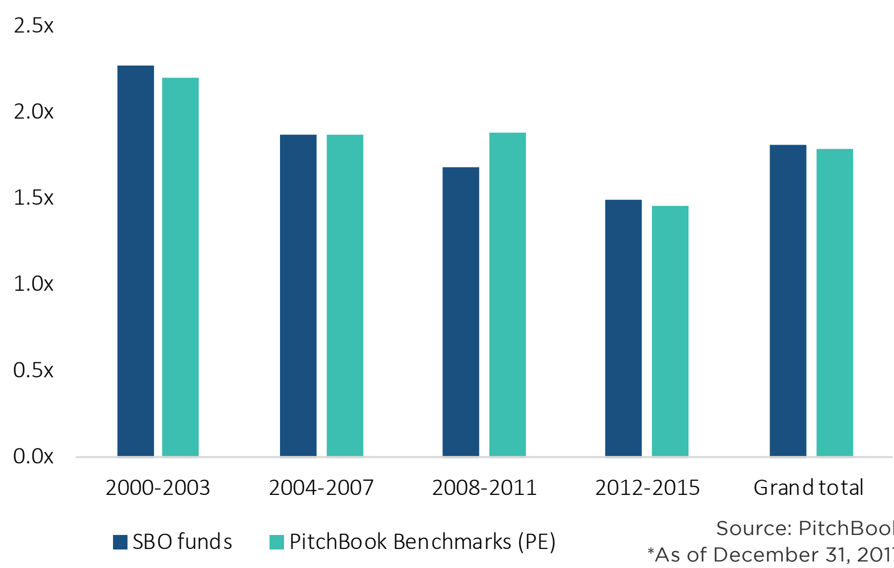
On a cash-on-cash basis, SBO funds perform on par with other buyout funds. Our sample of SBO funds posted a median TVPI of 1.39x for vintages 2000 to 2015, similar to the 1.43x recorded for PitchBook Benchmarks. Across all vintage buckets (which were grouped to augment sample sizes), SBO funds both over- or underperform, with no discernible pattern or difference compared to PitchBook Benchmarks. The same lack of variability is present in the best and worst performers; SBO funds produced a top-quartile hurdle of 1.81x across vintages 2000 to 2015 (compared to 1.79x for PitchBook Benchmarks) and a bottom-quartile hurdle of 1.19x (compared to 1.18x for PitchBook Benchmarks).

Median TVPI by vintage



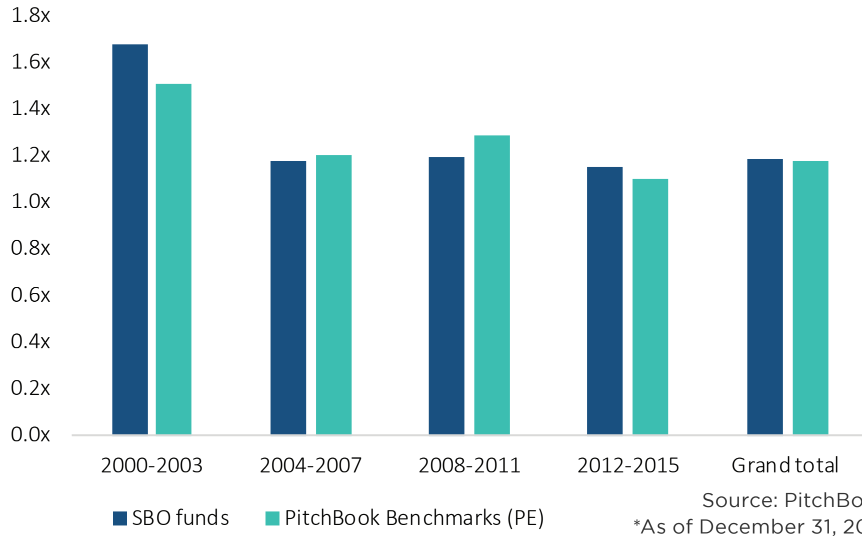
Source: PitchBook
*As of December 31, 2017

Top-quartile TVPI by vintage



Source: PitchBook
*As of December 31, 2017

Bottom-quartile TVPI by vintage



Source: PitchBook
*As of December 31, 2017

Additionally, we calculated how frequently SBO funds landed in any given quartile of funds within their PitchBook Benchmark peer group (defined by vintage year and strategy, in this case only buyout funds). 27% of SBO funds were in the top quartile of their peer groups, slightly better than would be expected from a randomly selected fund from PitchBook Benchmarks; however, 19% ended up in the second quartile, lower than expected, while 29% and 25% of funds ended up in the third and fourth quartiles, respectively.

Distribution of funds by PitchBook Benchmark quartiles (TVPI)

	Quartile 1	Quartile 2	Quartile 3	Quartile 4	Total
Sample of SBO funds	27%	19%	29%	25%	100%

Source: PitchBook
*n=100, quartiles based on terminal fund TVPI as of December 31, 2017

In addition to comparing cash-on-cash returns, we can compare fund performance based on IRRs to incorporate the irregular timing of cash flows. Given that platform companies acquired via SBO take slightly less time to exit (5.0 years) than do platforms acquired via primary buyout (5.2 years YTD as of May 2018), we expected to see better relative performance based on IRR than on cash multiples, but results were similarly mixed. Based on IRR, slightly more than half (56%) of SBO funds in our sample finished in the bottom half of their peer group. However, a full 25% finished in the top and third quartiles, as would be expected from any given fund from PitchBook Benchmarks (numbers do not add up to 100% due to rounding). Overall, we find no clear difference in performance between the sample of SBO funds and PitchBook Benchmarks.

Distribution of funds by PitchBook Benchmark quartiles (IRR)

	Quartile 1	Quartile 2	Quartile 3	Quartile 4	Total
Sample of SBO funds	25%	19%	25%	21%	100%

Source: PitchBook
*n=80, quartiles based on terminal fund TVPI as of December 31, 2017
Note: There are only 80 funds in the IRR sample since IRR inclusion criteria are stricter than for TVPI

Further considerations

Our performance data suggests that LPs should be largely indifferent to GPs' use of SBOs as a sourcing technique, though further research into this space is certainly warranted. Other considerations about the GP's strategy, such as deal structuring, operational improvement initiatives and inorganic growth opportunities, should carry more weight when making manager selection decisions. Finally, results may have been different if sampling were to target those transactions and funds with multiple rounds of PE ownership (more in step with the idea that some businesses are better suited for ownership by financial sponsors), presenting another area for further research.