Take a Second Look at Secondaries

Owners That Raise Their Value-Creation Game Can Excel
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Owners That Raise Their Value-Creation Game Can Excel

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Business commentators generally take a dim view of secondary buyouts (secondaries). They argue that returns on secondaries are unlikely to match those on primary buyouts (primaries), because the primary owner will have wrung all possible performance improvements from the asset. Critics also assume that secondaries are riskier than primaries.

**SECONDARIES YIELD STRONG RETURNS AT LOWER RISK**

New research from BCG, working in conjunction with HHL Leipzig Graduate School of Management, challenges the conventional wisdom. Drawing on one of the largest samples of complete primary and secondary buyout cycles ever compiled, we find that secondaries create just as much value as primaries sold to private-equity (PE) firms—while carrying substantially less risk.

**TO WIN WITH SECONDARIES, ENGAGE FOR GROWTH**

Secondaries that engage in mergers and acquisitions (M&A) return more than those that don’t. But M&A is just one of the many ways to create value at portfolio companies. The PE firms that achieve superior performance with secondaries in coming years will be those with the skills to use the value creation levers and organic top-line growth activities best suited to each company in their portfolios.
According to some of the world’s most respected business publications, secondaries—that is, private companies whose ownership passes from one PE sponsor to another—have little to recommend them. Consider a few representative mentions of secondaries—sometimes called “pass-the-parcel” deals—in the business press:

- According to an article in the February 25, 2010, issue of the Economist, “The risk of overpayment in a secondary buyout is great. Once a business has been spruced up by one owner, there should be less value to be created by the next.”

- An article in the April 19, 2010, Financial Times asserted that “pass-the-parcel deals can be unpopular with investors, who often have holdings in both the buyer and the seller. In that case the investor ends up owning the same asset with 30 percent of fees and carried interest—a profit share—taken out of the sale.”

- On August 22, 2012, an article on CNNMoney.com noted that “once a private-equity firm has bought and sold an investment, most private-equity buyers struggle to add value the second time around.”

Such critiques have taken on additional resonance as secondary buyouts have become an increasingly prominent feature of the PE landscape. (See Exhibit 1.) Secondary and later-stage deal volume in the first nine months of 2012 was roughly $56 billion, accounting for 34 percent of PE deal volume, according to Preqin, a clearinghouse for information on alternative investments. Further, activity in secondary and later-stage transactions is likely to remain high for the foreseeable future, owing to the steep decline in the volume of public-to-private deals, the moribund state of the market for initial public offerings (IPOs), continuing efforts by PE firms to deploy capital accumulated during the buyout boom, and pressure from investors for the return of some of the funds they invested in earlier years.

**Secondaries and Primaries Offer Comparable Returns**

Given that secondaries are here to stay, it is important for PE investors to be aware that there is little empirical foundation for the typical criticisms of their performance. We analyzed extensive data from first-quarter 2006 through third-quarter 2012 that enabled comparison of the returns on 225 PE holdings with at least two consecutive documented buyout cycles. (See the sidebar “Unprecedented Deal Data.”) Our analysis revealed several striking findings on secondaries’ returns.
Most significantly, we found that the returns on secondaries actually matched or even exceeded the returns on primaries sold to PE firms. The median annual return on the secondaries in our sample was 24 percent, compared with 20 percent on primaries. In addition to rivaling returns on primaries, returns on secondaries were notably less volatile than those on primaries. The standard deviation from the annual return rate was 0.244 for secondaries, compared with a standard deviation of 0.317 for primaries. In other words, not only did secondaries yield comparable or even better returns than primaries, they did so with lower risk.

As for operational improvements, both primary and secondary owners in the sample captured comparable efficiencies. Bottom-line performance was nearly identical, with the earnings before interest, taxes, depreciation, and amortization (EBITDA) of primaries growing at a compound annual rate of 14 percent, while EBITDA at secondaries grew at a compound annual rate of 13 percent. As for the top line, both the primaries and the secondaries in our sample generated compound annual sales growth of about 10 percent. These are especially important findings, because they convincingly refute the argument that secondaries offer little value-creation potential. In fact, our analysis shows that secondary owners produce top-line and bottom-line improvements on a par with those generated by primary owners. (See Exhibit 2.)

M&A Plays a Key Role in Value Creation

Another key finding suggests strongly that M&A activity, not leverage, is the surest route to improved returns on secondaries. Among the companies we analyzed, the median return on secondaries that engaged in add-on M&A was 25 percent, com-
pared with a median return of 15 percent on those that did not. (See Exhibit 3.)

Curiously, despite the clear correlation between M&A and enhanced returns, less than 30 percent of the secondaries in our sample engaged in M&A. What makes this finding particularly puzzling is that PE firms are well aware of the potential of M&A to increase the operational value of their portfolio companies. According to BCG’s most recent survey of PE professionals (included in the report Private Equity: Engaging for Growth, January 2012), M&A is the primary value-creation lever, ahead of such alternatives as geographic expansion and sourcing.

UNPRECEDENTED DEAL DATA

Secondary buyouts are nothing new, but little formal research and analysis have been done on them—until now. The Boston Consulting Group has teamed with HHL Leipzig Graduate School of Management to gather and analyze data on a representative sample of primary and secondary buyouts. It is a unique and robust database, and the findings of our joint analysis reveal new insights into the performance and value creation potential of secondaries.

The data set, spanning first-quarter 2006 through third-quarter 2012, covers 225 PE holdings with at least two consecutive documented buyout cycles. Included are 48 primary buyouts and 64 secondary buyouts for which full accounting information at the time of entry and exit is available, as well as 80 primaries and 69 secondaries for which deal values at entry and exit are available. To achieve maximum comparability of returns and operating metrics, the data sample includes only those primaries that were exited through secondary buyouts. Deals exited through alternate routes, such as trade sales and IPOs, were excluded.

Companies in the consumer and manufacturing sectors had the heaviest representation, making up 35 percent and 30 percent of the overall sample, respectively. Our operational-performance analysis is limited to European transactions, because privately held U.S. companies are exempt from most financial-reporting requirements.

Data for each transaction include several attributes that allow for a range of analytical perspectives:

- Type of entry
- Type of exit (trade sale, secondary buyout, tertiary buyout, or IPO)
- The holding periods for each individual deal and portfolio company
- Deal strategy (that is, buy-and-build, roll-up, or organic growth)
- Detail on M&A or divestiture activity
- Other relevant considerations, such as the characteristics of the PE investor, its mode of governance, and deal size

The broad range of data allows us to analyze secondary buyouts in more detail and with greater precision than achieved in earlier research.
The superior returns of “buy-and-build” secondaries—that is, those secondaries that engaged in add-on dealmaking, as opposed to those that did not—were driven by the synergies and operational improvements that the deals generated. The ratio of EBITDA to assets increased at a markedly greater pace among secondaries that made at least one add-on acquisition—growing at a median 4.9 percent compound annual rate versus 3.3 percent among secondaries with no add-on acquisitions.

**EXHIBIT 3 | M&A Drives Returns and Improves Operating Performance at Secondaries**

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<thead>
<tr>
<th>Deal returns by acquisition strategy</th>
<th>Operative improvements over holding period</th>
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<tbody>
<tr>
<td>Annual returns (%)</td>
<td>EBITDA and sales, CAGR (%)</td>
</tr>
<tr>
<td>Secondaries with at least one add-on acquisition</td>
<td>23</td>
</tr>
<tr>
<td>Secondaries with no add-on acquisitions</td>
<td>13</td>
</tr>
<tr>
<td>EBITDA-to-assets ratio, CAGR (%)</td>
<td>Secondaries with at least one add-on acquisition</td>
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<td>Secondaries with no add-on acquisitions</td>
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<tr>
<td>Sales-to-assets ratio, CAGR (%)</td>
<td>Secondaries with at least one add-on acquisition</td>
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<td>Secondaries with no add-on acquisitions</td>
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**Source:** Joint research on secondary buyouts by BCG and HHL Leipzig Graduate School of Management.

**Note:** The sample contains only those companies for which accounting data were available. The numbers shown represent median values.
The opposite held true when it came to the ratio of sales to assets. Among secondaries that executed at least one add-on acquisition, the sales-to-assets ratio declined at a median 4.6 percent compound annual rate compared with a median compound annual growth rate of 0.5 percent among secondaries that made no acquisitions. The fact that asset growth outstripped sales growth among secondaries that engaged in M&A implies that all or most of the sales growth at buy-and-build secondaries was achieved through inorganic means—that is, through M&A. We believe the data indicate that sales at those secondaries could have grown more strongly (in relation to assets) had their owners more fully deployed the sales improvement levers available to them.

**Tertiary Buyouts Are a Viable Exit Strategy**

Just as the business press views secondaries as a second-rate transaction type, many PE practitioners view tertiary buyouts (tertiaries) as the exit of last resort—to be engaged in only if a portfolio company is not ready to go public, the market’s IPO window is closed, or strategic buyers show little interest in the asset. Our analysis of the returns from various exit options, however, does not support this widely held view.

Our research shows that the returns on secondaries exited through the tertiary channel were within striking distance of the returns on trade sales. Among the portfolio companies we analyzed, 46 were sold to tertiary PE buyers, while 23 were acquired by strategic buyers. The annual median return on the tertiaries was 21.5 percent, compared with 25.8 percent on the trade sales.

Secondaries that were exited through a sale to a tertiary buyer also held up well in terms of operational-performance metrics when compared with secondaries that were exited through a trade sale—although not as well as those exited through an IPO. At secondaries exited through an IPO, and for which relevant accounting data are available, EBITDA grew at a median compound annual rate of 30 percent. Only eight of the transactions that we analyzed (13 percent of the sample), however, exited through this route. Among the 16 portfolio companies in our sample that were exited through a trade sale and for which relevant accounting data are available, the median ratio of EBITDA to sales (“EBITDA margin”) was 17.5 percent at the time of entry, compared with 16.6 percent at the time of exit. For the 40 companies that were exited through a tertiary buyout and for which relevant accounting data are available, the EBITDA margin was 13.7 percent at the time of entry and 16.0 percent at the time of exit. With little evidence that the IPO market will revive in the near future, investors in secondaries need to be aware that tertiary sales remain a viable option.

Secondaries that were exited through a sale to a tertiary buyer appear to have achieved efficiency improvements throughout the holding period. The lesson of this finding is clear and applicable to all secondaries, not just those that are exited through a tertiary buyout: secondaries offer the potential to create significant value through improvements in operational efficiency, provided those improvements are identified and executed throughout the holding period—that is, between the day the acquisition closes and the day the exit is complete.
Better Value Creation Drives Better Performance

Our findings represent a strong challenge to common assumptions about secondaries—particularly the belief that secondaries are worn-out assets whose best value-creation days are behind them. That belief needs to be reexamined in light of the evidence we have compiled. While our analysis is not the final word on the subject, it is a starting point for discussion and action.

We have singled out add-on acquisitions and the benefits of synergies as key success factors in achieving returns on secondaries that are comparable to those on primaries. In the future, however, pursuing those objectives may not be sufficient to realize secondaries’ full potential. Engaging in M&A is just one of the many ways in which PE firms can and should engage with their portfolio companies.

More broadly, we believe that the PE firms that achieve superior performance with secondaries in the coming years will be those with the skills to use the value creation levers and organic top-line growth activities that are best suited to each company in their portfolios. The mix of levers and activities will differ from one company to the next and will be more varied and intensive than simple buy-and-build strategies. As BCG’s report *Private Equity: Engaging for Growth* points out, PE firms can take advantage of a wide array of value-creating levers and activities, including sales force optimization, strategic pricing, and growth in emerging markets. We believe that to maximize returns on their holdings, PE sponsors of primaries and secondaries alike should use the full value-creation toolkit, while continuing to pursue buy-and-build strategies and realize synergies in their portfolio firms. The PE firms with the talent to bundle and execute these initiatives most effectively will be the firms that win the next round of the buyout game.

NOTES
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