Value Creation in Buyouts
Value-enhancement practices of private equity firms with a hands-on approach

Bachelor Thesis within Business Administration
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Abstract:

Swedish private equity firms have demonstrated a historical success in the buyout industry. However, current trends in the industry such as institutional changes, phenomenon of capital overhang and an influx of new entrants have intensified competition among buyout firms. To maintain the expected high gains, private equity firms must actively create values for their portfolio companies. The purpose of this study is to describe and analyze how private equity firms with a hands-on approach add value to the companies under management.

A literature review on value-creation by private equity firms was conducted. The value-creation methods were classified by the authors under the four themes: governance engineering, financial engineering, operational engineering, and strategic redirections. In order to collect the empirical data, the authors chose an inductive approach, used semi-structured interviews with representatives from five private equity firms.

The results show that the studied firms undertake to a large extent similar actions when it comes to corporate governance and financial engineering. With governance engineering, the firms attempt to strengthen the portfolio companies’ governance system through proper due diligence, the appointment of a competent and independent board of directors, an appropriate and deep management incentive program, establishment of a close relationship with management, and periodic management reports. The key to efficient governance is to give the portfolio firms 100% focus on operational and strategic issues in the board meetings. All but one firm use significant debt to lever the buyouts as it is evident that the pressure of debt repayment incentivizes management to better handle scarce capital.

Operational engineering and strategic redirection are the two themes in which the firms mainly distinguish themselves. Operational engineering largely concerns running operation more efficiently through a combination of cost-cuttings (divestment of non-profitable product and customer, outsourcing, centralizing purchases) and higher revenue growth (finding new markets, providing more after-sale service, extending product range). Strategic redirection incorporates the focus on core competences, making strategic decisions about investments, divestments, and add-on acquisitions.

There have been differences in actions taken by the studied firms. Factors that could affect the behavior of private equity firms are the type of companies acquired, the firm size, their perception of risk and reward regarding a particular action, as well as years of experiences in the industry. There is no common timeframe for actions taken by the studied firms. Nevertheless, all firms emphasize the importance of implementing fundamental changes in the early years of the investments.
Table of Contents

1 Introduction .................................................................................................................. 1

1.1 Background ............................................................................................................. 2

1.2 Problem Discussion ............................................................................................... 3

1.3 Purpose .................................................................................................................... 4

1.4 Delimitations .......................................................................................................... 4

2 Research Design ....................................................................................................... 5

2.1 Methodology .......................................................................................................... 5

2.2 Research Approach ............................................................................................... 5

2.3 Literature Review ................................................................................................. 6

3 Theoretical Framework ............................................................................................. 7

3.1 Governance Engineering ....................................................................................... 8

3.2 Financial Engineering ........................................................................................... 12

3.3 Operational Engineering ....................................................................................... 14

3.4 Strategic Redirection ............................................................................................. 15

3.5 Summary of Value-Creation Methods .................................................................. 17

4 Method ....................................................................................................................... 19

4.1 Company Selection ............................................................................................... 19

4.2 Data Collection .................................................................................................... 20

4.3 Data presentation and analysis ............................................................................. 23

4.4 Method evaluation ............................................................................................... 23

5 Empirical Findings ................................................................................................... 25

5.1 Private Equity A ................................................................................................... 25

5.2 Private Equity B ................................................................................................... 30

5.3 Private Equity C ................................................................................................... 34

5.4 Private Equity D ................................................................................................... 37

5.5 Private Equity E ................................................................................................... 40

6 Analysis ....................................................................................................................... 44

6.1 Target companies and Investment criteria ......................................................... 44

6.2 Governance Engineering ...................................................................................... 45

6.3 Financial Engineering ........................................................................................... 49

6.4 Operational Engineering ....................................................................................... 51

6.5 Strategic Redirection ............................................................................................. 53

6.6 Timeframe ............................................................................................................. 55

7 Conclusions ............................................................................................................... 56

7.1 Reflections on the Study ....................................................................................... 58

7.2 Further Research .................................................................................................. 58

References ..................................................................................................................... 59

Appendix 1 - Interview questions ................................................................................. 62

Table of figures

Figure 1 Buyout investment as a J-curve ....................................................................... 30
1 Introduction

The introduction provides the reader with an understanding of why the authors have chosen the particular field of study. This section also gives the reader a brief background on the buyout market, followed by a discussion of the current trends and challenges faced by private equity firms. These challenges will lead to the problem discussion and the purpose of this thesis.

Private equity emerges as an alternative financing source to bank loans and other types of financial instruments, such as stock and bond issuance. The fundamental operation of private equity firms is to acquire full or partial ownership stake in unlisted companies of high-growth potential, finance and assist in their growth, and sell them in 3-5 years. In Sweden and other European countries, the term “private equity” refers to one that makes investments in other companies at different stages, including seed and start-up, expansion and buyout (EVCA, 2007; SVCA, 2007). This paper focuses entirely on buyout investments and aims at examining what private equity firms do to enhance value of their portfolio companies following the buyout. The term “buyout” refers to an investment in mature companies that normally possess strong cash flow (SVCA, 2005). The authors choose to study this topic for three reasons.

First, in the 1990s private equity firms’ return mainly came from multiple expansions. Using this approach, the firms sought to buy a business at a low multiple\(^1\) (e.g., at a P/E of 4) and sold it in the subsequent years at a higher multiple (P/E of 7) thanks to the prospective industry growth. In doing so, private equity firms earned large profit without adding values to the portfolio companies (Mills, 2000). However, unlike traditional investors, private equity companies have more to offer than just “pumping” money. A study by Heel & Kehoe (2005) affirms that the most successful firms are those who actually pursue an active ownership strategy. This raises the authors’ question of the extent to which private equity firms get involved in the management of the portfolio companies. Thus, a study of how private equity firms contribute to value advancement of the acquired companies merits our attention.

Second, Swedish private equity-backed companies are reported to out-perform companies listed on Stockholm Stock Exchange (SSE) and all Swedish companies as a whole. The yearly average growth rate of sales recorded for private equity-backed companies was 21% compared to that of 7% for public companies and 1.5% for all Swedish companies during the period 1999-2004 (NUTEK & SVCA, 2005). This further reinforces the authors’ interest to gain an understanding of the dynamics behind their success.

Finally, the authors’ reason for only focusing on the buyout market is that the acquired companies have already reached a mature state. Therefore, it is easier to analyze how actions taken by private equity firms may make a difference than if the companies are in a continuous state of change (e.g. seed, start-up or expansion).

This paper is a Bachelor thesis within Corporate Finance, written at Jönköping International Business School. The paper will begin with a brief overview of the historical development of the world buyout market and a discussion of emerging trends in the buyout in-

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\(^1\) Multiple is a ratio, such as price/earnings ratio (P/E). P/E is the most common measure of how expensive a stock is. It is equal to a stock’s market capitalization (stock price \(x\) number of outstanding shares) divided by the after-tax earnings over a 12-month period (the fiscal year).
dustry. The background will be followed by a problem discussion that connects to the development within the private equity industry, and together these two sections form the foundation of which the authors formulate their purpose. The chosen limits for this thesis will then be explained as well as the philosophical approach that will characterize the methods used by the authors. The authors next review a set of value-creation methods extracted from recent articles, debates and finance textbooks. To enhance the credibility and reliability of the study, the research methods chosen are described in details. Results gathered from interviews with selected private equity firms in Sweden will then be presented. In light of suggestions from financial theorists and practitioners, a comprehensive analysis will be performed to justify the value-creation methods used by these firms. The paper ends with concluding remarks drawn from the study and suggestions for further research.

1.1 Background

The worldwide buyout market has experienced more than twenty-five years of significant development since its start in 1980s. The U.S. and the U.K. are by far the largest buyout markets in terms of both the number and the size of the deals. 2005 closed out as one of the hottest years for the private equity market in the U.S. with $200 billion worth of deals completed (McCarthy & Alvarez, 2006). The U.K also noted a record high of $35 billion in the total market value of buyout transactions in the same year (Wright, Renneboog, Simons & Scholes, 2006). Although there have been few deals dating back to the early 1980s, buyout markets in continental Europe did not materialize until 1996. The later half of the 1990s witnessed a substantial growth in this region. The total value of buyout acquisitions recorded in 14 countries increased ninefold, from $10 billion in 1996 to $89 billion in 2006 (Wright et al., 2006). In view of the strong growth in the last decade, buyout markets worldwide are believed to exhibit continuous expansion and to play a crucial part of the takeover market in the coming years (McCarthy & Alvarez, 2006; Wright et al., 2006).

Though the statistics show a remarkable development as a whole, the size of different buyout markets in continental Europe varies markedly. France, Germany, Italy and the Netherlands have been the most active within the buy-out industry (Wright et al., 2006). Nevertheless, in its recent yearbook 2007 the European Private Equity & Venture Capital Association (EVCA) has recognized Sweden – the focus of the authors’ study, as an emerging phenomenon of the buyout industry. In 2006, investments made by private equity firms in Sweden accounted for 1.44% of the country’s GDP, which surpassed 1.26% recorded for the U.K as well as the rest of Europe (EVCA, 2007). According to the Swedish Private Equity & Venture Capital Association (SVCA), 81% of these investments were committed to buyout deals (SVCA, 2007).

The main reason for this evolution has been the exceptional returns generated by the private equity firms. “U.S. private-equity groups like Texas Pacific Group (TPG), Berkshire Partners, and Bain Capital and European groups like Permira and EQT deliver annual returns [for their investors] greater than 50% year after year, fund after fund” (Rogers, Holland & Haas, 2002, p.96).

Despite the upside potential of the buyout market, recent studies have revealed current trends that intensify competition among buyout firms throughout the world. The first challenge facing the private equity sector is a phenomenon known as “capital overhang”. Capital overhang refers to the fact that “too much capital is chasing too few deals” (Wright et al., 2006, p.53). The attractiveness of the buyout market has enabled private equity firms to draw billion-dollar funds from institutional investors, including pension funds, fund-of-funds, and banks. Yet, the investment has not kept pace with the amount of fund-raising.
Europe is estimated to have $40 billion of capital overhang (Wright et al., 2006). Sweden is not an exception with €12 billion waiting to be invested (SVCA, 2007).

In addition to excess capital, new players have entered into the buyout industry. Sweden has traditionally been dominated by a number of domestic firms. However, the historical success demonstrated by them has attracted several international investment firms to establish their presence in Sweden (Ståhl & Leffler, 2006). At the same time, there have been institutional changes in the buyout market. Most of the deals in Sweden today are structured through controlled auctions arranged by investment banks. Prior to the submission of final bids, participating firms are required to perform due diligence\(^2\), financing and Sales and purchase agreement (SPA) negotiations (Ståhl & Leffler, 2006). On one hand, these legal requirements ensure a greater access to information among investors. On the other hand, bidding firms incur larger sunk costs that often give rise to a contract race so as to avoid forgoing committed capital (Ståhl & Leffler, 2006).

The ready availability of financing along with an increased number of active buyout funds and institutional changes, have led to a more efficient market (McCarthy & Alvarez, 2006). Kaplan explains that private equity firms were once believed to scavenge for undervalued assets, leverage them with debts, produce short-term profits and flip the investments (Jensen et al., 2006). However, the presence of a highly competitive and more efficient market implies a formidable task in searching for such undervalued deals (Bernstein, 2006). An observation that private equity firms are paying higher and higher prices in current transactions posing threat of shrinking profit margins, has further reinforced this belief. Instead of acting as arbitrageurs, it is predicted that private equity firms will have to increasingly differentiate themselves through their operating capabilities (Wright et al., 2006). The practice in which private equity firms take an active part in managing their portfolio companies is referred as a “hands-on” approach (Arundale, 2004). The key for firms lies in their ability to add value to the portfolio companies by embarking on new strategies, exerting a managerial discipline and sometimes by implementing a novel business model (Rogers et al., 2002; McCarthy & Alvarez, 2006).

1.2 Problem Discussion

The increasing competition has led private equity firms to seek for new practices through which they can increase the value of their portfolio firms. When performing a buyout, private equity firms hope to make profits through the increase in value of their portfolio companies. If considering an efficient market theory, private equity firms need to take actions in order to add value to their portfolio companies. This was also confirmed by Heel & Kehoe (2005) who found that the most successful private equity firms are those that pursue an active ownership strategy.

The current global trends in the private equity sector, such as “capital overhang”, new entrants, and controlled auctions have not missed out the Swedish market. This implies an increase in competition and higher bids when searching for buyout deals. Private equity firms in Sweden are also reported, by SVCA, to outperform companies listed on SSE and Swedish companies as a whole. It is therefore interesting to understand the actions private equity firms, with a hands on approach, in Sweden take in order to realize these values.

\(^2\) Due diligence refers to the investigation of a business
Value creation in buyouts has also captured the attention of many academics and practitioners. As the buyout industry is more mature in North America and the UK, many of the studies are conducted in these two regions. Research conducted in North America and the UK tends to generalize the value-creation methods used by private equity firms to all companies. However, the characteristics of Swedish portfolio companies may differ from those in North America and the UK. In addition, private equity firms in Sweden may choose to behave differently and adopt different methods to increase the value of their portfolio companies. It is therefore interesting to compare the methods used for value-creation by private equity firms in Sweden with those described in the literature.

The current literature mainly discusses the various methods used by private equity firms for value creation, but often ignores specific actions taken. In addition, it is not always specified why particular actions are taken and when they are taken during the investment horizon. These issues should also be examined, in order to fully understand the value creation process by private equity firms. A deeper understanding of the motives behind these actions and their timings will shed light on how private equity firms in Sweden, with a hands-on approach add value to their portfolio companies. An empirical study of several private equity firms in Sweden may well address these issues.

In order to address the issues discussed in this section and to fulfill the research purpose the following questions will guide this study:

1. What actions are taken by private equity firms to add value to their portfolio companies when engaging in buyouts?
2. Why these particular actions are taken?
3. When are these actions taken during the investment horizon?
4. Why are these actions taken in this particular timing?

1.3 Purpose

The purpose of this study is to describe and analyze how private equity firms with a hands-on approach add value to their portfolio companies.

1.4 Delimitations

This thesis is conducted from a purely Swedish perspective. The authors seek only to gain an understanding of the buyout market in Sweden.

In addition, the authors do not intend to generalize the actions taken by the studied firms to the whole industry. Instead, the authors seek to gain an understanding of what actions are taken to create values and the reasoning behind these actions. Further, the authors do not seek to testify whether and by how much value is actually created after private equity firms have implemented those actions.
2 Research Design

This section explores issues concerning the design of the study. The authors will describe the chosen philosophy and approach to the study as well as how the literature review was conducted.

2.1 Methodology

In order to fulfill the purpose of this study and to answer the research questions, the authors had to decide on a research philosophy and approach. According to Saunders, Lewis & Thornhill (2007), the research philosophies that researchers adopt capture the different assumptions in which they view the world. The researchers’ basic beliefs about the world have an effect on the research design, data collection and analysis of the data (Hussey & Hussey, 1997). The researchers’ philosophies and beliefs lead to a choice of research paradigm. “A paradigm is a way to examine social phenomena from which particular understanding of these phenomena can be gained and explanation attempted” (Saunders et al., 2007, p112).

The two main paradigms in research are positivism and interpretivism (i.e., phenomenology). These two paradigms can be regarded as two extremes of a continuum. Those who are purely positivists seek the fact or cause of social phenomena. They see the world as objective and external, and normally look for observable and measurable data. The researcher tries to stay independent and objective. On the other hand, those who are purely phenomenologist see the world as socially constructed and they try to minimize the distance between the researcher and the inquired. Findings are more subjective and often relay on the researcher’s interpretation. Positivism is argued to be the dominant paradigm in business research. However, phenomenological approach is becoming more acceptable and perhaps more appropriate in many studies within business (Hussey & Hussey, 1997).

Most of the literature on value creation by private equity tends to follow more a positivistic philosophy. Most of the theories treat value creation in an objective way and generalize value-creation methods to all private equity firms. Many theories simply assume that by taking particular actions private equity firms may add value to their portfolio companies. However, in reality, the value creation process may vary in different cases, companies, situations and perhaps timeframe. Hence, the authors do not believe that actions leading to value creation can be well captured in a single model. Instead, actions taken by private equity firms aiming at value creation should be studied in their context.

The authors believe that studying this topic from a more Phenomenological view may supplement the current literature. The aim is not only to describe the actions taken but also to explain why particular actions are taken. That may help to understand why different firms may undertake similar or different actions for value creation.

2.2 Research Approach

The extent to which a researcher is clear about the theory at the beginning of the study may determine the adopted research approach. The researcher can typically choose to adopt a deductive approach, an inductive approach or a combination of the two. A deductive approach aims at developing a hypothesis derived from a theory and thereafter testing it. An inductive approach aims at theory developing as a result of data analysis. The two approaches are normally attached with different paradigms. Deductive approach is normally associated with positivism whereas inductive with interpretivism (Saunders et al, 2007).
This study reviews previous studies on value creation by private equity firms. The intention with the literature review was not to build a hypothesis and then test it, but rather to thoroughly understand the topic and build some foundations for the empirical study. The methods and arguments put forward in the literature are compared with the empirical data collected in this study. This enables the authors to critically evaluate the actions taken by private equity firms in this study as well as to determine whether these firms follow the actions suggested in the literature or adopt additional actions. In addition, other issues that are often ignored in the literature such as why and when particular actions are taken are addressed in this study.

Building up hypotheses of what actions are assumed to be taken and then testing them are not suitable for the purpose of this study. Moreover, the results from this type of research may be shallow and have little explanation to why the phenomenon occurs. An inductive approach is more suitable as this study seeks to find reasoning behind the actions taken by the private equity firms. This study is therefore following an inductive approach, in which theory is intended to be developed.

The type of data collected in this study is qualitative, which is, according Saunders et al (2007), non-numerical or non-quantified data. The nature of this study required qualitative data, as the researchers seek to capture the actions taken by the participating firms as well as to reason why and when these actions are taken. Quantitative data, which is according to Saunders et al. (2007) numerical or quantified data, is not suitable for the purpose of this research, as it cannot develop reasoning and explanations to why a phenomenon occurs.

2.3 Literature Review

The first step of this study was to conduct a literature review on value creation by private equity firms. The purpose with the literature review was to explore what has been written up to date on the topic and to identify gaps in the literature.

The literature review relied mainly on articles from academic journals. According to Saunders et al. (2007), journals are a vital source for any research. The articles were searched on different databases. The main databases used in this study were Business Source premier, Web of Science, Emerald and S-WoBA. The use of multiple databases ensures that fewer relevant articles are missed out. Different combinations of the terms “private equity”, “Portfolio company(ies)”, “Buyout(s)”, “Value”, “Hands-on” and “active ownership” were used in the search. Abstracts of the articles were first read in order to determine their relevance. The relevant articles for this topic were then read thoroughly and key arguments and ideas were noted down.

A “snowballing” technique, in which additional articles were picked from references provided by relevant articles, was also applied. This enabled the collection of key theories on the topic that had been referenced by other authors. Another advantage is the collection of additional articles that might have been missed out due to the “wrong” key words in the primary search. The literature search reached a level of sufficiency when the authors encountered the main references over again.

The literature was organized in themes and sub-themes that emerged from the articles. These themes were also supported by relevant Finance books. Although books are presented in an ordered and accessible manner than journals, the material they provide may be out of date (Saunders et al, 2007).
Academic journals are considered rigid and provide trustworthy information. However, the peer review process, which is common in academic journals, may also cause time lags between writing and publishing. The outcome may be old-dated information with relatively less relevance. It was, therefore, important in this study to review information from current newspaper articles such as Financial Times and Dagens Industri that may keep the authors updated on the current trends in private equity. Major Internet websites concerning private equity in Sweden and Europe, such as SVCA and EVCA, were extensively reviewed. Reading updated information was crucial to understand the current trends in the private equity market.

3 Theoretical Framework

In this part, the literature concerning value-creation methods by private equity firms in buyouts is explored. The actions suggested in the literature are organized under four main themes and are summarized in a table at the end of this section.

The literature on private equity suggests a variety of methods to how private equity firms can add value to their portfolio companies. In this section, the authors organize the different methods for value creation suggested by current literature into four main themes: governance engineering, financial engineering, operational engineering, and strategic redirection. The first three themes were suggested by Kaplan as the main sources for value enhancement (Jensen et al., 2006). Many other authors have also argued for different aspects of value creation that could be classified under these themes. Corporate governance was suggested as a cornerstone in value creation by many studies (e.g., Millson & Ward, 2005; Nisar, 2005; Jensen et al., 2006). Other issues related to financial structure and operation were also widely discussed in the literature (e.g., Rogers et al., 2002; Arundale, 2004; Jensen et al., 2006). The fourth theme has emerged from several articles (e.g., Rogers et al., 2002; Lieber, 2004; Zong, 2005) since strategic redirection also leads to value creation by the private equity firms.

The authors base their review around these themes as each presents a different dimension of value creation. Furthermore, these four themes capture the vast amount of methods and tools for value creation suggested in the literature. Each theme is discussed extensively, including key concepts, methods and tools for value creation used by private equity firms as explored in the literature. Though the authors organize the methods for value creation under the four themes, they can also complement each other and somewhat overlap. Some issues may relate to more than one theme. For instance, the change in capital structure, which is a part of financial engineering, may also have consequences for governance engineering and operational engineering. Therefore, these four themes should be viewed as part of an interactive process, leading to value creation.

The review starts with governance engineering, as it has received much attention in the literature and it is one of the major sources of value creation by private equity firms. Financial engineering follows with a discussion of the financial aspects and their effects on the portfolio companies. Operational engineering is presented next, followed by strategic advices. Finally, the main issues of each theme are summarized in a table at the end of the section in order to ease the reader with reviewing different aspects of value creation.
3.1 Governance Engineering

The theme “governance engineering” refers to the strengthening of corporate governance of portfolio companies. Eun & Resnick (2007) define corporate governance as “the economic, legal, and institutional framework in which corporate control and cash flow rights are distributed among shareholders, managers, and other stakeholders of the company” (Eun & Resnick, 2007, p. 78). In that sense, corporate governance is an attempt to protect shareholders’ rights by developing mechanisms to deal with the agency problem.

Agency problem

The essence of the agency problem is the separation of ownership and control. The problem is studied under the agency theory, which is the analysis of the conflicts between managers and shareholders. Agency theory has received much attention in the economics literature (Jensen, 1986). Jensen and Meckling (1976) define the agency relationship as a contract between at least two persons, a principal and an agent. In the context of a corporation, the firm’s owner – the principal engage the managers – the agent, to perform some service on behalf of him, which includes entrusting the agent with residual control to run the company. However, the principal can never assure himself that the agent will do what benefits the principal the most. By assuming that both parties in the relationship are utility maximizes, it is believed that the agent instead of acting on the principal’s interest, will act upon his own interests first.

According to Arnold (2005), one of the main sources of the agency problem is the asymmetric information between the finance providers and the managers. Finance providers do not always have direct access to internal information of the company, which may cause them additional risk. For example, managers may spend money on projects that have much higher risk than what is acceptable to the investors. This scenario is referred to as moral hazard.

Another issue that may cause conflicts of interests is the distribution of profits to shareholders. According to Jensen (1986), payouts to shareholders reduce managers’ power, as resources outflow from the organization. Further, managers are keen on managing larger firms. Retaining profits increases the size of the firm and thus, enhances their power.

A particular form of the agency problem brought forward by Jensen (1986) is what he called, the “free cash flow” problem. Jensen (1986) explains that companies with ample cash flow find themselves having more cash than what is needed to undertake profitable investments. It is then a duty of mangers to distribute the free cash amount to the shareholders. Unfortunately, mangers of these cash-rich companies are tempted to retain the cash and in many cases, waste money on low-return projects. The unproductive use of cash will eventually cause the destruction of the firm value. Eun & Resnick (2007) further argue that the free cash flow problem tends to be more serious in those firms at mature stage with limited growth opportunities. Meanwhile, the targets of buyout investments are usually well-established firms in mature industries.

Another form of the agency problem is the under-investment behavior. Investors of public companies and financial analysts tend to overemphasize quarterly performance (Zong, 2005). The pressure to show profitability in the short-run causes managers being reluctant to invest in projects that only generate profits in the long run. Although these projects may add tremendous values to the company, they require a large investment and sometimes show a negative cash flow in the current period, which investors will not be happy about. Such under-investment behavior is likely to result in losses of shareholder wealth.
No matter which form that the agency problem may take, the main issue pointed out by Jensen (Jensen et al., 2006) is the absence of active investors. According to Jensen, managers left unchecked and unmonitored by investors were the cause of massive inefficiencies across corporate America in the late 1960s and 1970s. Many attempts to restructure defective corporations took place in the U.S. in the later periods, in which leveraged buyout (LBO)\(^3\) and private equity contributed an important part. Jensen believes that there is potential for large value gains from strengthening corporate governance and compares the emergence of private equity with the “rebirth of new active investors” (Jensen et al., 2006, p.11). Other authors researching on private equity firms (e.g., Rogers et al., 2002; Zong, 2005; Heel & Kehoe, 2005; Wright, 2006) also advocate corporate governance as the traditional way for value creation by private equity firms.

Numerous ways to cope with the agency problem in the particular context of leveraged buyout and private equity have been proposed. In addition to interest alignment, other objectives of corporate governance are to ensure the transparency of managerial activities and to have a proactive management ownership (Zong, 2005). These three objectives can be obtained simultaneously by employing several mechanisms.

**Board of directors**

*Size and structure of the board*

The first step is to appoint an independent board of directors. Jensen points out that the size of the board is relatively small under the private equity governance system (Jensen et al., 2006). Private equity firms typically appoint a general partner(s) to represent them on the board (Rogers et al, 2002). The rest of the board may be made up of the company’s largest shareholders (Jensen et al., 2006). Further, Kaplan suggests that private equity firms welcome industry experts to the management board to assist the portfolio companies in their development (Jensen et al., 2006). The interviews with 27 buyout experts by Millson & Ward (2005) affirm that having non-executive board representation is seen to be crucial by private equity firms. Further, Jensen strongly supports splitting the jobs of the CEO and the board chairman (Jensen et al., 2006).

The appointed general partner goes beyond the role of an administrator by adopting a hands-on approach to the management of the portfolio companies on behalf of the private equity firm. The general partner is responsible for all aspects that lead to value advancement of the portfolio companies. The scope of the general partner’s work ranges from developing long-term strategies, crafting business plans, to designing an incentive system and having ongoing dialogue with management on operational and strategic issues (Rogers et al. 2002; Zong 2005).

As mentioned earlier, private equity firms often involve the company’s largest owners in the board of directors (Jensen et al., 2006). The lesson drawn from the private equity industry is to let shareholders actively participate in the management process. Controlling shareholders are encouraged to question and influence managers’ decisions, make key compensation, and directly get involved in hiring and firing managers (Rogers et al., 2002; Zong, 2005).

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3 Leveraged buyout (LBO) is a type of buyout where a significant level of debt is used to construct the capital structure the acquired company (EVCA, 2007).
According to Jensen, there are significant differences in the kinds of discussions taking place in the board meetings of public companies and those of private-equity backed companies. In pricing the deal, the buyout principals go through a due diligence process, which enables them and the managers of the target company to learn more about the business. An extensive knowledge of the business is believed to raise the quality of those discussions, compared to public companies. Jensen further observes that there are a lot of conflicts and disagreements during public board meetings. Decisions are often made by voting. And due to disagreements, business issues that come up are ended up with no vote and are never resolved. The board of private-equity backed companies, instead, intensively discuss the issues, generally reach agreement and everybody is happy at the end of the day (Jensen et al., 2006).

To keep their detailed specific knowledge of the business, its customers, suppliers, competitors, employees, and so on, staying up to date, Jensen supports a close contact to be maintained between the board and the managers (Jensen et al., 2006). Feldberg, a Senior Adviser at Morgan Stanley, notices that directors representing private equity firms meet with the CEO and other members of management every couple of weeks for years. The meetings will typically address operational and strategic issues (Jensen et al., 2006).

The management team

Hoesterey reveals that the management team can benefit from the wide knowledge and experience of those employed the private equity firm. In some extreme cases, the private equity firm can decide to change the entire management team (Jensen et al., 2006). Heel & Kehoe (2005), however, suggest that replacing a management team should be done at the early stage of the investment. Berg & Gottschalg (2004) refer to this process as removing managerial inefficiencies.

Incentive mechanism

The board of directors have many tools at its disposal to align manager’s interest with those of the owners. In their study of sixty buyout deals done by eleven leading private equity firms, Heel & Kehoe (2005) find out that the most successful deals involved establishing a proper performance-based incentive program. Significant changes in performance-based incentives are often cited by famous researchers and practitioners as a conventional way to better align the interest of managers with that of shareholders (Gregory, 2000; Jensen et al., 2006). The incentives can take different forms but the most common ones are pay-for-performance incentives and share options. The successful deal partners in Heel & Kehoe’s study (2005) reported to have a system of rewards equalling 15-20 percent of the total equity, depending on the firm performance. With share options, management has the right to buy ownership stake in the company at a stated (i.e., exercise) price some time in the future (Fabozzi & Peterson, 2003). An important feature of these incentives is to replace cash payment with equity grant. By doing so, managers’ interest is more closely tied to the interest of the owners (Gregory, 2000).

In addition to equity grant, private equity firms often require managers to make significant investment in the business (Heel & Kehoe, 2005; Jensen et al., 2006). According to Kaplan, the rationale behind this is to create both upside and downside for managers. Managers should not only be rewarded for improved performance but must also share losses resulting from poor performance. By contributing their own money to the company, managers are as likely to gain as to lose depending on the firm’s performance. To a great extent,
managers are motivated to run the business in a way to maximize shareholder value, not to
destruct their own wealth (Jensen et al., 2006).

Regarding the scope of the incentive program, Moon – Managing Director and founding
partner of Metalmark - stresses the importance of giving incentives to the right people. Eq-
uity grant should not be limited to the CEOs or top managers. “Equity should be pushed as
deep into the organizations as there are people who move the needle” (Jensen et al., 2006, p.23).

Another issue in structuring the compensation is the liquidity of the equity ownership.
Kaplan emphasizes that it is insufficient to provide managers with significant equity. More
importantly, management’s equity must be made illiquid until the increase in value is
proved. In another way, managers can not sell stocks or exercise options until they have
created value to the company (Jensen et al., 2006). Millson & Ward (2005) reveal that the
right to exercise share options should be conditional upon meeting performance targets or
only be enforceable after a specified time period.

**Due diligence**

Another mechanism to monitor managers’ conduct is to carry out a transparent due dili-
gence. It is particularly important to perform the due diligence in the early stages of the in-
vestment. Heel & Kehoe (2005) reveal that the best-performing deal partners devote half
of their time on the company during the first 100 days and meet almost daily with top ex-
ecutives. According to Jensen (Jensen et al., 2006), the due diligence process unearths in-
formation about the company and enables private equity firms to learn about the business.
In that sense, Moon emphasizes that the due diligence helps to minimize the information
gap that causes the agency problem (Jensen et al., 2006).

**Reporting and Performance indicators**

Millson & Ward (2005) find out that dedicated private equity firms have a high need for ac-
cess to monthly management accounts, weekly review of sales and margins, and frequent
meetings with managers and visits to the company site.

Finally, private equity firms establish an appropriate set of indicators to track the com-
pany’s performance. 92 percent of the best-performing deals examined by Heel & Kehoe
(2005) implemented such a performance management system.

Top private equity firms in the study by Rogers et al. (2002) reported to zero in on few fi-
nancial indicators that most revealed the company’s progress in enhancing its value. These
firms believed that a broad array of measures complicated rather than clarified the discus-
sions and hindered rather than speeded up actions. Their most commonly-used measures
were cash flow ratios and return on invested capital (ROIC). Rogers et al. (2002) argue that
private equity firms prefer to track cash rather than earnings because earnings can be ma-
nipulated. Zong (2005) agrees with the focus on cash. She further explains that it is the
high portion of debts in buyout deals making cash a scarce resource to private equity firms.
Therefore, they tend to watch cash more closely. The reasoning for using ROIC, as ex-
plained by Rogers et al. (2002), is to reflect actual returns on the money put into the busi-
ness.

Together with corporate governance, private equity firms can capitalize on their financial
skills to improve the firm’s performance. The next section synthesizes value-adding activi-
ties within the scope of Finance.
3.2 Financial Engineering

Finnerty (1988) defines financial engineering as encompassing “the design, the development, and the implementation of innovative financial instruments and processes, and the formulation of creative solutions to problems in finance” (Finnerty, 1988, p. 14). According to this definition, the activities within financial engineering can be classified under three branches. The first is securities innovation, which involves structuring and developing new financial instruments (e.g., the introduction of Eurodollar deposits in the early 1960s). The second branch deals with the development of innovative processes aimed at reducing transaction costs, such as electronic security trading. The third branch focuses on finding creative solutions to corporate finance problems (Finnerty, 1988).

The scope of financial engineering covered in this study confines to the last branch since structuring leveraged buyouts, according to Finnerty (1988), is a central corporate finance issue for private equity firms. The task demands the firm to determine and execute a course of actions from financial perspective that lead to value enhancement. Jensen (1986), Rogers et al. (2002), Zong (2005), Kaplan & Ferenbach (Jensen et al., 2006) and Wright et al. (2006) suggest that buyout firms can implement financial engineering by employing more debt in deal structuring and by converting traditional assets into new sources of financing.

Debt financing

Costs and benefits

Buyout transactions are typically characterized by the intensive use of debt financing, hence the name “leveraged buyouts” (Wright et al, 2006). In structuring the buyout deal, private equity firms often resort to a large amount of debts in addition to their own investment. Zong (2005) studied that approximately 60% of private equity-backed companies’ assets are financed with debts and 40% is the typical amount for public companies. Financial theorists and practitioners advocate the extensive use of debts for strategic reasons.

As discussed earlier, the agency problem of free cash flow tends to be a serious sickness of mature firms that are the target of buyout transactions. According to Jensen (1986), the pressure of leverage is believed to provide a stronger mechanism than equity to help control the free cash flow problem. Jensen argues that creditors, unlike shareholders, have the legal rights to take action against companies that fail to service debt payments. In that sense, they impose a discipline on managers. Managers are motivated to curb private benefits and wasteful investments. At the same time, they must work hard to ensure that the company is able to repay its principal and interest.

From financial aspect, debt is a cheaper source of financing compared to equity. Creditors are the first claimants on the company’s assets and thus, face a lower default risk in the event of liquidation (i.e., bankruptcy). Therefore, they are willing to accept a lower interest rate in return for the security of debt repayment (Damodaran, 2001; Berg & Gottschalg, 2004). Further, interests paid on debts are tax-deductible in most tax regimes. This tax advantage is translated into a lower cost of debt, hence a lower cost of capital. Since most methods used to compute the firm value involve discounting a stream of cash flows by the cost of capital, a lower required rate of return will lead to significant value acceleration (Damodaran, 2001).

Though the firm value may be augmented by employing a higher leverage, increasing the amount of debts comes at cost. The benefits of debt financing as a low-cost source of fund are based on the assumption that the cost of borrowing remains unchanged when the firm
takes on more debts. However, this is not truly the case. A higher debt ratio exposes the firm to greater default risk and thus, reduces investor-confidence. As consequence, the firm’s credit rating may be downgraded, which in turn raises the cost of borrowing. At this point, the argument for the cost advantage of debt financing is weak. It does not necessarily follow that a higher leverage will lower the cost of capital (Damodaran, 2001).

In addition, the pressure of leverage is intended to create operating efficiency and sound corporate governance. The outcome of using too much debt, however, may produce a reverse effect. Damodaran (2001) and Eun & Resnick (2007) suggest that there is only potential for value gains if embarking on more debts moves the company towards its optimal debt ratio. Otherwise, it will cause an under-investment problem, where risk-averse managers are discouraged to pursue profitable but risky investment projects.

Private equity firms must also take into account the loss of operating and financial flexibility for managers of the portfolio company. In structuring the loans, creditors often impose restrictive covenants on the firm’s managers to monitor their behavior. Some of the restrictions may constraint the firm from financing future investment projects, such as the type and amount of new debts that can be issued (Damodaran, 2001).

*Optimal financing mix*

Again, there is no single optimal financing mix that can be applied to all firms. The choice of capital structure is rather firm-specific (Damodaran, 2001). In determining how much debt should be used, private equity firms must weight the benefits of debts against the cost of increasing operating risk and default risk. Alan Jones – Head of Corporate Finance – at Morgan Stanley, proposes that buyout firms should firstly address the question of whether the acquired firm is having excess cash or unused debt capacity (Jensen et al., 2006). The answer to this question will help measure the impact of levering debts more accurately. While assessing the effects of a higher debt ratio, Pinegar & Wilbricht (1989) suggest that firms should carefully examine the following factors: predictability and stability of cash flow, possible dilution of common equity’s claims, liquidity of the firm’s assets, loss of financial flexibility, corporate tax rate, and increase in operating risk.

*New debts instruments*

To mitigate the risks associated with debt financing, active players in financial markets have come up with new debt instruments. Some common types of debts that are used in buyout transactions include second-lien loans⁴ and mezzanine debts⁵. Both fall under the category of subordinated debts. These debts often carry a higher interest rate compared to senior (first-lien) debts but lower than the required rate of return on equity. To the extent that they typically impose fewer restrictive covenants, managers have more operating flexibility. However, they fail to address the problem of lost financial flexibility. The company is limited in its future financing options in the sense that potential conflicts might arise between

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⁴ Second-lien loan is a simple loan with a subordinated security structure and/or no security (i.e., no asset pledged as collateral). Principal and interest on second-lien loans are settled after other senior debts have been paid. Due to the increased inherent risk, second-lien loan is set at a higher interest rate than first-lien debts.

⁵ Mezzanine debt is a relatively large loan, typically unsecured or with a deeply subordinated security structure (e.g., third-lien loan). In compensation for the increased risk, mezzanine debt providers often require a high interest rate and a detachable warrant, which is an option to purchase the company’s bonds or stocks at a given price in the future.
the first- and second-lien providers. Providers of subordinated debts will not be happy if the company takes on more senior debts, which have a higher priority over debt settlements (Wright et al., 2006).

Conversion of traditional assets into new sources of financing

Roger et al. (2002) study that the most sophisticated private equity firms have created new ways to obtain a more efficient capital structure and to lower the cost of financing acquisitions by converting traditional assets into sources of financing. Though this is not applicable to all firms, it is particularly important for those that have a large amount of cash tied up in fixed and non-cash current assets (Rogers et al, 2002). With the introduction of asset-backed securities, for instance, firms are able to raise additional capital by securitizing assets of these kinds. A firm that owns a piece of real estate to lease or has a substantial amount of account receivables may issue securities backed by a stream of cash flows from these assets. In doing so, the firm frees up cash flows that would be otherwise strapped in non-cash assets. Since these securities are often set at a lower interest rate compared to bank loans, it further benefits the company by reducing the cost of borrowing (Miskhin, 2000).

Owing to the favorable conditions in the 1990s (strong economic and stock market growth, the ready availability of the capital market and the abundant source of deals), private equity firms relied essentially on financial engineering skills as their primary way of value enhancement (Lieber, 2004). In today’s challenging environment, the use of financial engineering alone can no longer guarantee the success of buyout funds (Lieber, 2004; Wright et al., 2006). Kaplan explains that in order to preserve profitability, it is important that private equity firms combine financial engineering with other methods, such as corporate governance and operational engineering (Jensen et al., 2006).

3.3 Operational Engineering

Private equity firms may make use of their knowledge and experience to improve the current operation of the portfolio company (Arundale, 2004). This can be referred to as operational engineering. Operational engineering has gained an increasing importance since the 1980s after the introduction of auctions caused the prices of the deals to rise. Consequently, private equity firms could not maintain the attractive level of returns and a large part of profits has been transferred to the seller. Private equity firms have responded to dwindling profits by developing industrial knowledge and by welcoming experienced former executives on the management board in order to help enhancing the value of the portfolio companies. Kaplan argues that holding a greater level of industry knowledge and expertise insures private equity firms to have the best practices in their portfolio companies, thus levering gains (Jensen et al., 2006).

Moon explains that the operational engineering starts outright from the due diligence process, when the private equity firms discover more information about the portfolio companies and the industry than has ever been known by the companies themselves. The operational engineering then continues as an ongoing and collaborative process. Private equity firms meet on a regular basis with managers of their portfolio companies and discuss op-

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6 Asset-backed securities (ABSs) are financial securities that are secured by the cash flows from a specified pool of underlying assets. The assets pool could comprise any type of a company’s receivables ranging from credit card receivables, auto loans, and asset leases to royalty payments.
erational and strategic issues along with the financial matters (Jensen et al., 2006). The specific expertise of the private equity firms may lead to value generation through improvements in the operational performance of the portfolio companies that would not have been possible to be achieved on their own. Through their knowledge and expertise, private equity firms contribute a source of extrinsic value generation. Further, private equity firms also develop these qualities from their experience in previous acquisitions (Berg & Gottschalg, 2004).

According to Hoesterey, private equity firms can draw on their network of professionals, investors, and external resources to support their portfolio companies (Jensen et al., 2006). Using this network, private equity firms can provide their portfolio companies with additional contacts, including potential customers, suppliers and other finance providers (Berg & Gottschalg, 2004).

Further, value can be generated by a fundamental change in the financial performance of the portfolio company, i.e. either by improvements of revenues or margins or by the reduction of capital requirements. Revenue growth and cost cutting may lead to an increase in margins. Reduction of capital requirements can be realized by freeing up resources or by reducing the cost of capital, due to better financing terms or change in the capital structure (Berg & Gottschalg, 2004).

Private equity firms can often reduce the portfolio companies’ costs by eliminating operating expenses that do not generate revenues. Further, private equity firms can increase margins by divesting or terminating unprofitable projects. Investments that earn less than the cost of capital will actually cause a net cash outflow. In such cases, it is generally more profitable for the firm to cease the investments (Damodaran, 2001).

Freeing up resources can be achieved by the reduction of required fixed or current assets. (Berg & Gottschalg, 2004). Money tied up in non-cash working capital items such as inventory and account receivables reduce the company’s cash inflow. If the company is able to reduce net working capital requirements by reducing account receivables and inventory or by increasing account payables, its cash flow will increase and so does the company value (Damodaran, 2001).

Apart from operational improvements, private equity firm may also have an active role in a more long-term strategic direction of the portfolio company. Private equity firms may guide their portfolio companies with various strategic advices throughout the investment horizon.

### 3.4 Strategic Redirection

A number of studies (Rogers et al., 2002; Zong, 2005; Heel & Kehoe, 2005) assents that the most successful private equity firms actively participate in the strategic decision-making of their portfolio companies. To develop a good investment strategy, buyout firms can follow some guidelines provided by these studies.

A study by Rogers et al. (2002) reveals that top private equity firms determine an investment strategy at the beginning of the investment horizon. Rogers et al. (2002) refer to this strategy as an investment thesis, which lays out the fundamental change needed to transform the company in 3-5 years. Developing an investment thesis involves identifying the main problem inherent in the existing business model or a unique opportunity that could help the company make a leap. The private equity firm will then define a strategy aimed at re-
shaping the business model or exploiting the opportunity. Zong (2005) further advocates that buyout firms should apply a laser-focus strategy. Instead of pursuing multiple goals, the investment thesis should target only one goal; the achievement of which leads to higher profitability and increases the firm value. Zong argues that chasing multiple goals is likely to cause a divergence of goals and dispersion of resources.

After defining the investment thesis, the next step is to construct a business plan to execute the strategy. According to Zong (2005), the plan concentrates on two or three strategic issues that are directed towards goal attainment. The business planning process involves a frequent interaction between private equity firms and management of the portfolio companies. Private equity firms evaluate the management’s plan skeptically and develop their well-researched viewpoint to challenge managers (Heel & Kehoe, 2005).

Private equity firms can incorporate a *scenarios plan* in their business planning. Best/worst scenarios can be modeled by simulating market factors, company cost and revenue factors. Such a contingent plan helps the portfolio company be more flexible in the strategic decision-making and better react to unexpected events (Lieber, 2004).

Moon & Hoesterey stress the importance of that private equity firms should have a long-term focus when giving advice on strategic issues. First, an effective communication plan will help private equity firms better understand managers’ intention and help managers being aware of the emphasis on long-term gains (Jensen at al., 2006). Further, the long-term perspective should be embedded in the investment thesis that focuses not on cost-reduction but on entrepreneurial activities (Rogers et al., 2002; Mills, 2006).
### 3.5 Summary of Value-Creation Methods

<table>
<thead>
<tr>
<th>Main Themes</th>
<th>Value-creation mechanisms</th>
<th>Tools</th>
</tr>
</thead>
</table>
| Governance engineering | Incentive program | • Establish performance-based incentive program: equity grant and share options  
• Require management’s investment in the business |
| | Independent board of directors | • Appoint a general partner  
• Involve industry experts, advisers, and largest shareholders in the board  
• Small size  
• Close contact with management |
| | Elimination of managerial inefficiencies | • Replace the current management team at the early stage of the investment if necessary |
| | Due diligence process | • Review periodical reports, arrange frequent meetings with management team, and pay visits to the company site |
| | Establishment of appropriate performance measures | • Use a simple set of measure that most reveal the underlying business  
• Carefully track cash flow ratios and ROIC |
| Financial engineering | Debt financing | • Determine a relevant debt ratio  
• Use new debt instruments (e.g., second-lien debts and mezzanine debts) |
<p>| | Conversion of traditional assets into new source of financing | • Issue asset-backed securities |</p>
<table>
<thead>
<tr>
<th>Operational engineering</th>
<th>Due diligence process</th>
<th>• Arrange frequent meetings and discussions with managers to understand the business</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Employment of industry experts</td>
<td>• Involve industry experts in the board to support the existing management team</td>
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<td></td>
<td>Provision of a network of contacts</td>
<td></td>
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|                         | Improvement of margins | • Find ways to promote revenue growth  
• Cut costs: eliminate undue operating expenses, divest unprofitable projects |
|                         | Reduction of capital requirements | • Reduce investment in fixed asset  
• Reduce investment in noncash working capital: reduce accounts receivable and inventory or increase accounts payable |
| Strategic redirection    | Defining an investment thesis | • Change or modify the current business strategy |
|                         | Constructing a business plan (incorporating a scenarios plan) | • Craft an action plan to execute the strategy |
|                         | Long-term focus | • An effective communication plan between private equity firms and management team |
4 Method

In this section, issues on how to select the participants, how to collect, present and analyze the data are discussed. The section ends with an evaluation of the chosen method.

4.1 Company Selection

The aim of a phenomenological study is to get in depth information and therefore, the research sample can be based on small number of cases (Hussey & Hussey, 1997). According to Saunders, Lewis & Thornhill (2003), as inductive approach is particularly concerned in the context in which events are taking place, a small sample may be more appropriate than a large one. There is a tradeoff between the size of the sample and depth of the study. The larger the sample size, the greater the generalizability of the sample on the population. However the internal validity gets weaker and the level of interpretation and understanding a phenomenon is lower (Hussey & Hussey, 1997). The focus of this study is on understanding the phenomenon of value creation by private equity firms. The intention is not to generalize a single model to all companies, as actions taken by private equity firms, towards value creation, may vary between cases and firms. The authors therefore believe that a relatively small sample will serve better the purpose of this study than having a large sample.

The SVCA’s website, which has an extensive database of private equity firms operating in Sweden, served as the primary searching source for potential participants. The authors limited the geographical area to include firms as far north as Stockholm to as far south as Gothenburg. The authors believe that focusing on only this region has no effect on the results of this study for two broad reasons. Firstly, most of the private equity firms in Sweden are located in between these two cities, so this region represents the majority of the private equity firms in Sweden. Secondly, this study does not intend to generalize to an entire population. Instead, it aims to develop understandings and focuses on a small number of cases.

As this study focuses on buyouts by private equity firms with a hands-on approach, additional searching criteria were set. All the companies in the chosen region were studied further through the SVCA website and their own websites. Potential participants should have explicitly stated on their websites that they have an active ownership or that they use a hands-on approach. In addition, they typically should have had buy-outs as a first priority of their investment phase.

After analyzing companies’ websites, 12 companies were found fitting the searching criteria. These firms were then contacted and briefed about the purpose of the thesis over the phone to establish first contact, and then later by email to explain the purpose more thoroughly. Four companies did not reply, even after extensive efforts to establish contact by the authors. Five companies declined the offer through email. The reasons given were lack of time, resources, and confidentiality of information. Finally, three firms were willing to participate.

The authors agreed that a larger number of firms would allow more actions to be identified. Hence, a secondary search had to be conducted. The criteria used when searching the SVCA and the companies’ websites were then broadened to include active firms that had buy-outs as a primary or secondary priority in their investment phase. The remaining criteria were kept and the second sample size contained five firms. These companies were then contacted, using the same method as in the first selection, and two additional firms agreed to participate. A total number of five firms were found sufficient by the authors to fulfill
the purpose of the study. The need for a second selection has no real effect on the results of the study as the participating firms in both selections have an experience from performing several buyouts and the questions to these firms focused only on buyouts. In addition, as this study does not intend to generalize, so extending the searching criteria to second priority in buyouts does not create any bias.

This selection method has both pros and cons. Studying the companies’ websites is relatively easy and not time consuming. It enables to have a greater focus and resources on the core of the study, the value creation. In addition, to look only for companies that explicitly state these criteria on their websites reduces the risk of including firms that do not fit the purpose of this study. However, there might also be companies, which fit to the searching criteria but do not state it explicitly on their websites. In that case, potential participants could have been missed out.

4.2 Data Collection

Different methods for data collection

There are few possible methods for data collection. The most common methods for data collection in academic research are observations, questionnaires and interviews. Observation involves “the systematic observation, recording, description, analysis and interpretation of people’s behavior” (Saunders et al., 2003, p.221). Questionnaires are concerned with data collection techniques in which each respondent faces the same set of questions in a predetermined order. Interviews involves a discussion between two or more people and it can help to gather a more valid and reliable data that are relevant to the research questions and objectives (Saunders et al., 2003).

As the aim of the study is to understand how private equity firms create value in their portfolio companies, observations in the private equity firms could have been an appropriate method for data collection. Observation is strong at explaining particular social situations and processes (Saunders et al., 2003). However, it can be very time consuming and therefore, not possible to be applied in this study due to time constraint. In addition, applying only observations may introduce an observer bias and would not help to explain fully why private equity firms chose to take particular actions.

Questionnaires may be a faster method for data collection. However, it provides the same set of questions to all respondents and it may be more appropriate when a large sample is required. In this study, private equity firms may create value in their portfolio companies using different methods. These methods could not be captured well in a single questionnaire that provides private equity firms with exactly the same questions. Instead, the study of each firm should include more open and flexible questions. That enables the researchers to ask particular questions that may apply to one firm but not another. In addition, questionnaires may suffer from a weak internal validity as respondents may misinterpret the asked questions (Saunders et al., 2003).

As the study is based on a small number of cases, interviews with the private equity firms was found suitable method for data collection. Interviewing a small number of participants is not much time consuming and it overcomes the deficiencies of questionnaires. Interviews have a stronger effect than questionnaires in this type of study, as they can provide a more valid data that is relevant to answer the research questions.
Interviews

There are three main types of interviews: structured, semi-structured, and unstructured. Structured interviews are normally based on questionnaires and include standardized or identical set of questions. In semi-structured interviews, the researcher has a list of themes that is needed to be covered. It is more flexible and the questions can be asked using a different order to fit the flow of the conversation. In addition, the researcher may decide to omit or add specific questions in particular interviews in order to fit the context. The data in this type of method is normally recorded using note taking or a tape-recording. Unstructured interviews are very informal and are used to explore in depth a general area. There is no predetermined list of questions and it gives the interviewee the opportunity to talk freely about events, behaviors and beliefs in relation to the topic (Saunders et al., 2003).

According Saunders et al. (2003) structured interviews are more suitable to a survey research in which quantitative analysis is applied. Semi-structured and unstructured interviews, on the other hand, are more suitable for a qualitative analysis as they develop discussions and place more emphasis on exploring the “why” and not only to reveal and understand the “what” and the “how”. As this study also focuses on why particular actions for value creation are taken by private equity firms, structured interviews are not suitable. In addition, structured interviews are quite similar to questionnaires, and therefore most of the arguments not to use questionnaires in this study are valid when considering structured interviews.

Semi-structured interviews were found more suitable for this study as they follow a list of themes. Although the study aims at theory development, the intended questions aroused from the themes explored in the literature review. Following the same themes in all the interviews enables the researchers to compare the findings and to explain why certain actions are taken in one case but not in another. Unstructured interviews may be more appropriate when the departing point of the researcher is the interviews and grounded theory is intended to be produced.

Interviews may be conducted “face to face” or through telephone (Saunders et al., 2003). The researchers in this study preferred to conduct “face to face” interviews at the private equity firms. However, in one out of the five interviews conducted in this study, it was only possible to conduct a telephone interview. The researchers believe that it may have no effect on the results as the telephone interview had the same duration and covered the same issues as the “face to face” interviews. In addition, the telephone interview was conducted using an audio conference in which all the researchers had the opportunity to listen and to ask follow up questions.

Before the interviews took place, a pre-study of the participating firms was conducted through their websites and press releases. The aim was to gather background information about the firms and to prepare for the interviews. The researchers could then ask the interviewees particular questions that arouse from the pre-study.

In all the interviews, confidentiality was assured to the interviewees so that they could feel more confident to explore the private equity firms’ operation. This is also the reason why the private equity firms’ names are not mentioned in this study. The authors chose to assign the term “Private Equity” plus an alphabetical letter to each firm. For instance, Private Equity A refers to the first firm interviewed, Private Equity B is the second firm, and so on. A tape recorder was used to record the data in all the interviews. It allowed the interviewers to focus thoroughly on the interviews with out any breaks for note taking. It also insured
that data was not missed out and that the interviewers could listen repeatedly to the recordings and interpret the small details.

The interviews were conducted in English, which is not the native language of the authors or the interviewees. In some cases, language barriers can affect the validity of the data collected. However, the language did not pose any difficulties on data collection in this study, as both parties are familiar with the language as well as the technical terms. In addition, the semi-structured interviews provided the parties the opportunity to acquire further clarifications when some information was not clear.

The authors would like to note that a single representative from each firm was invited to each interview. The interviews were conducted with Senior Partner responsible for Knowledge Management of Private Equity A, Board Chairman of Private Equity B, Investment Manager of Private Equity C, Partner and Managing Director of Private Equity D, and Chief Financial Officer of Private Equity E. Each interview lasted between one hour and one and a half hours. The fact that the representatives had different roles in the private equity firms is not likely to have a significant effect on the results as the private equity firms are relatively small and all of the interviewees have actively participated in previous acquisitions, regardless of their position in the firms. In addition, all the interviewees have been with the firms from the establishment and have a great knowledge of how the firms operate.

The interviewees were asked three main questions and additional follow up questions. The interview questions (see appendix 1) were also sent to the interviewees approximately 10 days before the interviews. This was done to enable the participants to prepare for the interviews and to understand what type of information was expected from them. The first question was only an introduction question and aimed to develop an understanding of what attracts the firms when evaluating a buyout. The second question was the core of the study and focused on value creation. The follow sub-questions followed the themes emerged from the literature review. The aim was to cover governance engineering, financial engineering, operational engineering and strategic redirection in the interviews. The sub questions were not asked in a predetermined order during the interviews. Instead, the interviewees were provided the opportunity to freely describe their operation and how they create value. The sub questions were only used to construct follow up questions if a theme was not covered thoroughly. The third question was asked at the end in order to determine whether there is a certain pattern in the action taken by the private equity firms and whether the timing of the actions matters.

**Follow-up after the interviews**

After the interviews, the authors provided the participating firms with additional questions by email. When the authors were not clear about the data collected in the interviews, a second contact with the interviewees was made to receive further clarifications. In order to increase the internal validity of the results and to reduce any sort of bias on the interviewers’ behalf, the empirical part of each private equity firm was sent out to the firm for a final confirmation. In all cases, a positive feedback was received and no further changes were required.
4.3 Data presentation and analysis

The nature of qualitative data has both implication on the data collection and data analysis. Data will probably need to be classified to categories before it can be analyzed as the nature of the data is often non-standardized and complex (Saunders et al., 2003). As the study employed semi-structured interviews, the data needed to be categorized in order to ease the analysis. After each interview the researchers transcribed the data from the tape recordings. The data was then classified according to the different actions that emerged from the interviews.

According to Saunders et al. (2003), there is no standardized approach to the analysis of qualitative data. Instead, there are several strategies and methods to the analysis of qualitative data put forward by the literature. The method or the strategy a researcher chooses depends on the intended analysis. In this study, the data is firstly presented case by case and then analyzed by incorporating the different cases together.

Presenting the five interviewed firms case by case is significant in this study. As the intention in this study is to identify different value-adding actions taken by private equity firms as well as to understand why these particular actions are taken, it is important to present the background and the operation of each firm separately. A drawback of this method is that presenting case by case is for some extent monotonous and some actions taken by the firms are repetitively presented in the different cases. However, integrating the cases together without describing the background for the actions would only enable a descriptive analysis and would not enable the development of analytical analysis, which discusses the motives behind the actions.

After understanding each firm's operation, a cross study of all the firms was conducted. The different actions and the motives behind the actions were then compared between the firms to find commonalities and deviations. The actions taken by the studied firms were also compared and evaluated with those suggested by the literature. This approach enabled to find patterns between the firms, to understand why certain firms favor particular actions, and to critically evaluate these actions with the literature.

The analysis is structured around the data emerged from the empirical study. However, the actions taken by the private equity firms were organized into the four themes emerged from the literature: governance engineering, financial engineering, operational engineering, and strategic redirection. This was done in order ease the review of the taken actions and to enable comparison with the existing literature.

4.4 Method evaluation

Trustworthiness is an important issue in any research. If a researcher gets the wrong answers, the trustworthiness of the study and its results would directly suffer. It is therefore important to ensure that the research method is adequate and that the findings are credible. According to Saunders et al. (2003), in order to reduce the chances to get the answers wrong, attention has to be paid to validity and reliability in the research design.

Validity

Validity can be distinguished between internal and external. Internal validity is whether the data provide a truthful reflection of what the study is intended to examine. External validity is whether the findings apply to people or situations outside the original investigation (Booth & Harrington, 2005). External validity is often referred as generalizability and the
two terms literally mean the same thing. Internal validity is high in phenomenological studies as the researchers normally gain full access to knowledge and meaning of those who are involved in the phenomenon (Hussey & Hussey, 1997).

Reliability

Reliability is concerned with the level of repeatability of the findings. If other researchers conduct a similar study, would they come up with similar results? Reliability is very important in positivistic studies for the findings to be credible. However, under a phenomenological study, reliability is given a lower weight (Hussey & Hussey, 1997). A lack of standardization in interviews may lead to concerns regarding reliability (Saunders et al, 2003). This concern may also arise due to issues of bias.

Reliability can be assessed by posing the following questions (Easterby-Smith, Thorpe, & Lowe, 2002:53 cited by Saunders et al., 2003):

- Will the measures yield the same results on other occasions?
- Will similar observations be reached by other observers?
- Is there transparency in how sense was made from the raw data?

The application of semi-structured interviews enabled the researchers to increase the level of both validity and reliability. The interviews followed predetermined themes, which enables, to some extent, replication of the interviews. However, the reliability is still limited as the questions were not completely standardized and different researchers could ask them in different ways. The interviews provide a high level of validity as questions could be made clear to respondents and the researchers could ask the interviewees for further clarifications if some data was not clear. This is also one of the strengths of interviews over questionnaires. The authors also recorded the interviews and thus, reduced the chance to miss out important information. In addition, the follow-up questions and the reconfirmation of the data by the firms ensured that this study provides truthful reflection of the data.

Two main sources of bias, interviewer and interviewee, may affect the validity and reliability of the results provided by the interviewers. Interviewer bias may appear when the comments, tone or non-verbal behavior of the interviewer affects the answers provided by the interviewee (Saunders et al, 2003). The authors in this study tried to be objective as possible during the interviews and provided the respondents the opportunity to explore the firms’ operations. However, interviewer bias cannot be eliminated entirely, as it is based on the interaction between two or more people and therefore may also be subjective. Interviewee bias may arise by providing limited information by the interviewee (Saunders et al, 2003). The findings in the study are based on the data provided by the interviewees and therefore, it is important to reduce this type of bias. This study is anonymous and therefore, there is no strong incentive for the interviewers to mislead the researchers. However, it is difficult to guarantee nil bias on the interviewees' behalf.

As the study is based on a small number of cases, the researchers do not intend to generalize on the entire private equity sector. According to Yin (1994, cited by Saunders et al. 2003), qualitative research using semi-structured interviews will not be able to be used to make generalizations on the entire population. However, Norman (1970, cited by Hussey & Hussey, 1997) argues that it is possible to generalize from only few cases if the analysis captures the interactions and characteristics of the phenomenon. In that case, concepts captured in the results may be transferable to other settings and environments. Although the actions taken by private equity firms in this study cannot be generalized, the reasons behind
the actions may help to explain why other private equity firms choose to take particular actions.

## 5 Empirical Findings

In this section, the findings from each interview will be presented separately.

Many times in this section, the readers will come across direct quotations. Wherever the authors place a sentence in quotation mark “…” and in italics, it is meant to be the direct statement of the interviewees. For instance, “Basically, we can only generate returns on the money that we invest in three ways either through operational improvements, multiple arbitrage or leverage effect” – this is a quotation of the direct statement made by the interviewee. By using quotations, the authors hope to bring the readers closer to the interviews and to give an authenticity for the information presented.

To make a distinction, the authors always refer to Private Equity A, B, C, etc. as “the firm”, and portfolio companies as “companies”.

### 5.1 Private Equity A

Private equity A is one of the largest players on the Swedish buyout market. Its main focus of investments is mid-sized companies within the European region. Among its acquisition targets are divisions or businesses from large corporations. Large corporations often own several divisions operating in various industries. Some of the divisions may not be their core businesses. In such case, the large corporations want to sell off these divisions. This is when Private Equity A steps in and buys the divisions from the large corporations. Industries of interest are light-manufacturing and service industries, which are not too capital intensive.

#### Investment criteria

Private Equity A relies on several criteria while searching for potential portfolio companies. Ideally, the target companies should be in a fragmented industry which provides consolidation opportunities (opportunity to acquire companies in other geographic areas). They should hold a good market position in a specialized niche, possess a strong management team, and show a steady cash flow. Having a sound cash flow is perceived to be “one main denominator” by Private Equity A “because of the leverage principle, which is being applied to private equity”. These companies are, however, not performing at their full potential for clearly identifiable reasons. To discover where unearthed value exists, Private Equity A continuously benchmarks companies in the same industry and/or those in different industries but having similar characteristics.

#### Deal structuring

Private Equity A incorporates both debt and equity when structuring the buyout deal. Typically the ratio is two-third debt and one-third equity. Private Equity A acknowledges the importance of using debt as a way to generate returns. The firm explains that debt is much less expensive than equity. While the required rate of return on equity is 20%, the interest rate on debt is between 7-8%. Although debt is a cheaper way of financing, it can impose a financial risk. Therefore, Private Equity A recognizes the need to find a ratio that is appropriate for each particular investment by estimating the future cash flow. Debt usu-
ally accounts for two-third of the deal value but it varies somewhat from case to case. If the company is cash-rich, the firm may use more debt.

Moreover, having a significant part of the acquisitions financed by debt puts pressure on managers to manage capital more efficiently. From the firm’s experience, many companies did not have their own finance function when they were parts of the large groups. “If they need money, they just draw on the check account which the groups have had”. In some cases, the companies may borrow from other divisions though they still have idle cash. Increasing the leverage attaches the need to repay debt, which makes cash a scarce resource. Therefore, managers are encouraged not to tie up unnecessary capital. “It means that people are then constantly chasing cash, making sure that you do not have idle cash…You are putting more a sense of urgency into the company”.

In structuring buyout deals, Private Equity A may use a mix of senior and subordinated debts. According to the firm, the specific structure depends on the size of the transaction, the equity proportion that it is prepared to provide, and the amount of senior debt that the bank is willing to lend. If their deal is not yet fully financed using equity and senior debt, Private Equity A may resort to mezzanine debt or vendor loan\(^7\) to bridge the gap.

Securitization is not commonly used by Private Equity A, though it has done so in few very specific cases. More often, the firm does sale-lease backs\(^8\) of real estate as a way of deleveraging the portfolio companies or raising extra cash for strategic add-on acquisitions.

**Active ownership**

*Network of experts and Board of directors*

The first measurement taken is always to add human capital to the portfolio company. In addition to its own sector knowledge and experience, Private Equity A has a wide advisory network, consisting of knowledgeable industrialists. To assist its portfolio companies, the firm assigns these competent people to sit on the board of directors. “We always put a new board in place”. These boards typically consist of six to seven people. There are usually three representatives from Private Equity A (two senior partners and one junior). They are the people, who have done the transaction. Then, the firm always appoints one external chairman, who acts as a link between Private Equity A, the rest of the board and the management. Two or three industry experts from the firm’s network will be brought in, depending on what kind of changes are to be made or what the challenges are.

Private Equity A also recognizes an advantage of keeping the board small. “If there is a need to take decisions, they can be taken very, very quickly”. As explained by the firm, everyone on the board has the same interest. Therefore, the board can be pooled together, which hastens the decision-making process. “It is a significant part of the success story”.

Board meetings are held on a regular basis, every second month during the first half year. In the subsequent periods, the board meets less frequently, four to six months. However, meetings between the board and the management are often arranged once a week and can

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7 Vendor loan is a loan from one company to another, which is used to buy the goods from the company providing the loan.

8 Sale-lease back is an arrangement in which one party sells an asset (e.g., property, machine) to a buyer and the seller immediately leases the asset back from the buyer. Sale-lease back allows the seller to make full use of the asset while not having capital tied up in it.
be as frequent as daily if there is much happening. By frequently interacting with managers, the momentum can be kept up in between board meetings.

During the meetings, the board members fully concentrate on discussing the business. Private Equity A recognizes the board’s focus on the business as the key success factor. According to the firm, some of its acquired companies were non-core businesses of big groups. While being owned by these large corporations, the companies were often left alone, known as “corporate orphans”. “They were basically given 40 minutes at the end of each 5 hour board meeting for their business, very little time to discuss new investments for expansion”. When Private Equity A becomes the owner, the companies are given “every second month 5 hours, full attention on their business”.

**Business Plan**

Together with the management team, Private Equity A develops a business plan. To a large extent, the business plan is based on the management’s belief in what is possible to achieve. The firm then actively challenges the management’s views.

Different scenarios covering base case, good case and low case are incorporated in the plan. The cases are constantly revised when the company progresses throughout the years. Private Equity A initially looks back at the history of the company, “ideally up to 10 years”. “So you can see your full business cycle and how the company has performed in that entire cycle”. This preliminary assessment helps the firm understand the cyclical characteristics of the company and the risks associated. After making fundamental changes, the firm will re-evaluates the business’s exposure to risk. For example, the company is now less exposed to risk by having better geographic mix and product mix. Understanding the risk will then enable Private Equity A to assume some growth scenarios – whether the company will grow with or quicker than GDP. Other factors that the firm builds into the base plan are the likelihood and timing of changes in public policy (e.g., privatization, deregulation) and the company’s sensitiveness to such changes. According to the firm, all these elements will affect the company’s capability for undertaking strategic actions in the future, such as add-on acquisitions.

**Management team**

Private Equity A changes the management team in 50% of the cases during its ownership. Motives behind these restructuring efforts can be many. For example, the portfolio company may enter into different phases of development (e.g., expansion, turnaround) that require distinctive skills by the management to implement fundamental changes in that particular period. In such case, Private Equity A may need to replace some management positions.

The firm usually brings in additional management. Quite often it adds a Chief Financial Officer (CFO) to the management team. When the portfolio companies were parts of big groups, they may not have their own finance function. Since the capital structure has changed, a CFO is needed to manage cash flow, debt and balance sheet. Also, the firm often brings in a Chief Operating Officer (COO). “Because if you are going to expand the operations, you need somebody who is able to focus on making add-on acquisition, to go in to new markets, and so on”.

To ensure that managers act for the interest of the owner and the company, Private Equity A documents a board guideline that sets out the responsibility of the board and the managers. There are certain matters that are strictly the board’s responsibility (e.g., changes in strategy, acquisitions, divestments, entering into major contracts).
Reporting and Key performance indicators (KPIs)

Private Equity A expects a detailed report to be handed in every month. A number of financial and non-financial KPIs are examined carefully, which enables the firm not only to track the company’s performance against the targets but also to spot new development trends. Examples of non-financial indicators are the number of clients gained and lost, change in average purchase value per customer, etc.

Incentive program

To align the interests of the management with those of the owners, Private Equity A uses a “carrot and whip approach”. First, managers are always required to co-invest with Private Equity A on similar terms and to sign-off on the Base Case, which is the whip. According to the firm, managers are motivated to work more efficiently. For instance, “they have a better incentive to reduce working capital because they can directly see that it affects their own share-holding”. Private Equity A perceives the willingness of managers to co-invest as an indication of the management’s belief in their own plans.

To give them additional incentives, the firm works with either option programs or similar, which is the carrot. If the managers perform better than planned, their ownership stake and value will increase. However, they are not allowed to sell their equity stake until Private Equity A sells its stake – the interest should be aligned.

Experience sharing

Private Equity A runs yearly “best-practice seminars”, where different management groups from all portfolio companies (e.g. purchasing managers, operation managers) gather to share know-how.

Operational improvements

As the firm points out, “90% of profits generated from buyout investments come actually from earnings growth”. Gains through other mechanisms, such as debt financing and multiple arbitrages are relatively small (14% and -7%, respectively). Earning growth is attained by making fundamental changes in the company.

“When we go into a company, we will look at all of its processes”. Looking through the whole process enables the firm to identify what aspects can be managed more efficiently. First of all, Private Equity A goes through the entire product floor, tries to identify high margin products and profitable customers “to reduce exposure to low margin products and to customers that are not really generating any profit for you”. Further, the firm seeks to find new markets for existing products, extend the product range, and provide more after-sale services. This is a combination of cost-cutting and sales and earnings growth.

Another operational aspect that the firm often seeks to improve is consolidating the purchase process. From its experience, many companies still have a history of letting each factory or sale division make its own purchases. “If you centralize the purchasing function, you have larger volume, which would give you bigger rebate from suppliers, which of course enhances your margin”. Centralizing purchases can also take place in the sale process, in which companies have one sale division specialize in one product line (e.g., food processing) and service customers living in different locations. The benefits perceived by the firm are “to get bigger economies of scale, get closer to the customers in being able to identify their needs, and also in being able to work with the customers. When the customers get value-added, they are prepared to pay for that”.

28
Working capital management is another area that Private Equity A often works on. Lots of improvements made are internal (things that the company is in control of). For example, cutting payment terms for customers or ensuring invoices to be sent in parallel with the goods. “We use a lot of consultants and advisers. We will bring in working capital expertise”.

Further, continuous benchmarking against competitors gives the firm additional information regarding potential operating improvements. For instance, an identical gross margin but lower EBITDA may signal opportunities for operating efficiency enhancement.

**Strategy**

Most of the unrealized value that Private Equity A sees in its portfolio companies is due to a lack of focus. Private Equity A does not change the strategy of its portfolio companies completely. Instead, it seeks to sharpen the strategy by concentrating more on core business activities and selling off non-core divisions. The money earned from the divestments can then be reinvested in the core business.

Private Equity A has a full-day strategy meeting every year. The firm sits and discusses with the board and the management what is going to happen in the next 2-3 years. “So you are constantly working with the strategy of the company because changes will happen”.

When investing in a company, Private Equity A always scans similar markets in other countries for potential add-on acquisitions. Add-on acquisitions are mainly of horizontal type, in which producers of similar or complementary products are acquired. After-sale service is a segment that the firm often seeks to expand to. “Quite often we try to expand to the after-sale segment because that is usually higher-margin”. Growing through add-on acquisitions is a big part of the firm’s value creation element. As explained by the firm, add-on acquisitions increase the size of the company. This in turn gives the company more control of the market and eliminates the risk of being driven out of the business. According to Private Equity A, portfolio companies might not be able to make add-on acquisitions earlier due to financial and/or knowledge limitations. Expertise in making add-on acquisitions and in financing these transactions is what the firm can bring to the portfolio companies.

Apart from add-on acquisitions, the firm may outsource some business functions to sub-suppliers. “In many cases, we come from doing a lot of in-house production to doing only assembly...because you think the engineering part and the after-sale service is really what you are best at providing. And the components can be made cheaper or better by somebody else”.

While working on strategy, Private Equity A emphasizes the importance of having a long-term view. According to the firm, private equity investment follows a J-curve (see figure 1). “Usually the first year will not be a very good year because you are taking costs, you are changing things. But the owners are happy with that and no body puts pressure on [managers]”. The firm and its owners know how it works and have patience for that. Moreover, Private Equity A recognizes the need of having a long-term value enhancing strategy if it wants to sell the company in the future. The potential buyer must be able to see the long-term growth prospect of the company.
Timeframe

Each acquisition is a unique case. “It is not that every company will follow exactly, because they are all different”. However, Private Equity A points out that some actions at the beginning of the ownership are mandatory, such as creating a base plan and putting together a board of directors. Also, the firm finds it important to build up a high momentum outright by implementing 100-day change program. “Doing most of the changes within the first year of your ownership enables a better result”. According to the firm, making early changes enables it to correct the actions if things have gone wrong.

5.2 Private Equity B

Since its establishment, Private Equity B has pursued 27 acquisitions and 63 add-on acquisitions. The firm searches for potential companies to invest from two main sources. The first source is divisions that are non-core businesses of large corporations. The second source is family businesses that seek for a change in ownership.

Investment criteria

While screening potential investments, Private Equity B looks at a number of selection criteria. First, the target company should have annual revenue, which ranges from SEK 200 million to SEK 3 billion. Second, the target company is usually a market leader in a well-defined niche. Third, the company has demonstrated its capability to generate strong and steady cash flow. Finally, there must be a potential to grow. Private Equity B often looks for companies with the possibility of doubling the profits in 4-5 years.

Private Equity B cited several reasons why these companies under-performed their potential. The primary reason is a lack of clear focus by many companies in their business strategy and operations. For divisions that are non-core businesses of large corporations, the parent firm is often reluctant to commit additional investments for development. For family businesses, there is often a lack of management and a great exposure to financial risk. The owner is solely responsible for the business and avoids carrying extra risk from financing growth and making add-on acquisitions.

Deal structuring

Private Equity B’s holding period is usually 3-5 years. It uses a significant amount of debt to finance buyout deals. The stability of cash flow is an important aspect for the firm to de-
termine how much debt should be used. Typically, the firm borrows between 50 to 75% of the transaction value.

Private Equity B provided several explanations to justify the firm’s use of high leverage. “Basically, we can only generate returns on the money that we invest in three ways, either through operational improvements, multiple arbitrage or leverage effect”. With operational improvements, the firm attempts to constantly increase the portfolio company’s operating margin. Due to high profitability, the company can be sold for a distinctively high price in a later period. With multiple arbitrage, the firm pays a certain multiple when it acquires the company and sell them at a higher multiple. In such case, the firm has made a positive gain without adding any value to the portfolio company. Finally, the leverage effect is due to the use of debt, which is a much lower cost of capital compared to equity. “Leverage is very important in order to generate the return on the equity we invest. If you don’t lever, the operational improvements have to be so significant” [in order to meet the required return on investments fully financed by equity].

In addition, having some debt contributes to operational improvements, particularly working capital management. From the firm’s experience, many companies typically tie up a large amount of cash in working capital (e.g., inventory or accounts receivable). Companies previously belonging to large corporations do not usually have to think about the capital. “They were just parts of big groups” and “If they needed more capital, they just called the CEO to bring in more capital”. After being bought by Private Equity B, the companies become independent and cash becomes a scarce resource. Leverage “is some sort of forcing the management to be efficient in terms of capital” in order to repay debts, by reducing significant working capital requirements.

In choosing debt instruments, the firm mainly uses senior debt and only a small faction of subordinated debt. Although subordinated debts impose fewer restrictions on managers, senior debt is far cheaper than subordinated debt.

Also, it is not conventional for Private Equity B to convert assets into additional source of financing by way of securitization. “That is more U.S type of situation…In the U.S., they have a more efficient, broader and deeper capital market. You can do lots of things in the U.S which you actually can’t do here in Europe”.

**Active ownership**

*Net work of experts and Board of directors*

Private Equity B emphasizes its ability to provide a large net work of industry advisers. Members of the network are the former CEOs and CFOs of the large Swedish corporations. “The critical issue for us is really to add thinking” and “to add a lot of people resources around the company on board level”. As a major owner of the portfolio company, Private Equity B appoints a completely new board of directors with competent people of specific expertise, depending on the specific needs of the portfolio companies. The board of directors often consists of five people: two from Private Equity B and three industry advisers. One of the industry advisers will become the chairman of the board. The CEO of the portfolio company never sits on the board and the board is completely independent of management.

The board of directors frequently interacts with the company’s management team, through formal board meetings and informal dialogues with the managers. During the first year, the

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9 Private equity B often acquires up to 90-100% of the portfolio companies.
board meetings take place on a more regular basis, roughly every month or every six weeks. In the latter periods, the board meets four to six times a year. However, there is much contact with the management team in between the board meetings. The chairman spends one or two days a week with the CEO.

The board of directors appointed by Private Equity B dedicates a hundred percent on discussing operational issues during the board meetings. “That is very important and beneficial to the company”. The decision-making process among the board members is less bureaucratic and politic. The CEO, the board of directors and the owners work closely with each other and all involve in the decision-making. If strategic decisions need to be made, they can be done quickly.

Business Plan

Private Equity B finds it very important to detail a business plan called the “Private Equity B’s base case”. Bad scenarios are also considered but all the investment decisions will be made according to the possible outcomes predicted by the base case, which is a very prudent case relative to the actual potential. “If things change along the route, we then revise the case”.

Management team

Private Equity B does not have big groups of managers to bring in the company and prefers keeping the existing management team. In assessing the management, the firm will look at their capability to implement the business plan. According to Private Equity B, the management needs to be prepared for high tempo and be able to undertake different actions simultaneously. The investment horizon is typically 4-5 years. Within this short time period, significant changes must be implemented and the goal of doubling profits must be achieved. Therefore, being able to take this tempo is important.

Reporting and key performance indicators

Beside the board of directors, other monitoring activities include monthly reports. Private Equity B does not appoint any independent audit committee. To follow up the company’s performance, Private Equity B develop a number of ratios. “It is especially important for us to look at operational improvements, cash flows and liquidity development”.

Incentive program

“There is always the management’s participation in the buyout deals”. The management is required to purchase between 5-10% of the equity ownership through options, sweep equity or other mechanics. By doing so, the management’s interest is closely tied to the owner’s interest and the company’s performance. In addition, the management is not allowed to sell their shares until the company is sold.

The scope of the equity program is not limited to the CEO. It varies on case-by-case basis. Private Equity B often consults with the CEO to determine who should be involved in this program. In some companies, there may be five or six managers. In other companies where there is a high degree of decentralization with a number of branch managers, there can be up to 50-60 involved in the incentive program.

Operational improvements

Private Equity B advances the performance of the portfolio companies through internal efficiency improvements. While improving the operating efficiency, Private Equity B is essentially
concerned with working capital management. To reduce the working capital, the firm hires an expert to investigate the situation (how much capital is tied up, why it is tied up, etc.). Based on this analysis, it determines how the working capital can be managed more efficiently. Specific actions vary from case to case. Other activities are cutting non-profitable product lines; investing in new production facility; changing the distribution network; improving logistic, supply chains, and warehousing; centralizing purchases to negotiate favorable prices from suppliers.

**Strategy**

Private Equity B observes that most portfolio companies have a less-focused strategy. When a company is bought by the firm, Private Equity B tries to sharpen the companies’ focus by divesting non-core businesses and expanding in areas, which the company is really strong at. “Focus and tempo in the process, we are actually doing that well”.

While reformulating the strategy and implementing necessary changes, the firm takes a long-term view. Private Equity B and the managers have a common understanding that many reengineering activities need to be undertaken during the early years of the investment. These activities may cause a dramatic drop in profits up to 12 or 24 months. “We have no problem with profits dropping as long as we believe in the managers”.

To grow the portfolio companies, Private Equity B embarks either on organic growth or add-on acquisitions. Growing the company organically includes expansion to new markets and introduction of new product lines.

Another way to grow the company quickly is making add-on acquisitions of either competitors or complementary businesses. According to Private Equity B, divisions that are parts of large corporations are not allowed to acquire other businesses. Again, the parent companies need money to invest in the core businesses and thus, are not willing to finance this kind of expansionary activity. In the case of family businesses, often the owner does not dare to pursue add-on acquisitions for fear of incurring additional risk. On the other hand, Private Equity B possesses strong expertise in Mergers and Acquisitions (M&A) activities, and add-on acquisitions are by far the largest source of value creation in its portfolio companies. Also, most add-on acquisitions are of horizontal type. “When we do add-on acquisitions, we are buying typically companies that are doing the same thing…We realize mainly economies of scale”. Instead of doing vertical integrations, Private Equity B outsources part of the business process if it enables the company to focus on its core activities (e.g., part of production chain, supply chain, or logistic chain).

**Timeframe**

There is no standard time frame for value-adding activities that could be applied across all buyout investments. However, Private Equity B has certain experiences in what needs to be undertaken first. One of the critical elements is to develop a detailed business plan at the beginning of the investment with the management and the board. The board of directors can be determined early, right from the due diligence process. It usually takes six to twelve months to buy a company. While investigating the business before the acquisition, the firm already knows exactly who will be on the board. Also, capital management is important and needs to be improved early. Otherwise, a detailed analysis must be done over time and a course of actions will be determined accordingly.
5.3 Private Equity C

Private Equity C primarily invests in small and medium sized industrial and trading companies in the Nordic region. These companies are often family businesses that their founders seek for a partner or a change in ownership. The goal of Private Equity C is to create value through industry knowledge, commitment and long-term ownership in its portfolio companies. The firm currently has six active investments.

Investment criteria

Private Equity C searches for companies with a strong growth potential, strong profitability, leading position in their niche, strong and professional management team and a potential interest for international investors. Private Equity C always buys already profitable companies and do not seek to make turnarounds. These investment criteria are argued by the firm to reduce the riskiness of the investment. Entering into already profitable companies with a solid cash flow reduces the risk of the leveraged acquisition. A strong management team with good industry experience is important, since it is the management who runs the company and reaches the targets the firm has set up.

When looking for potential portfolio companies, Private Equity C uses their networks, brokers, and corporate finance boutiques. The buyout is normally done through auctions in which several private equity firms participate. Before the acquisition, the firm does what it calls “industrial-due diligence” of the target company to see if it is of interest. It looks at the market as a whole and the company’s position in the market, what are the value drivers in the market, growth potential, and threats. After winning an auction a more deep “due diligence” is done on the company.

Deal structuring

The investments are financed by the firm’s shareholders, private individuals and bank financing. According to Private Equity C, the fact that the firm does not have a fund, differs it from many other private equity firms. “We try to take a more long term view”. The firm is not restricted to sell its investments after 2-5 years. Private Equity C claims that the length of ownership is much more flexible. If Private Equity C feels that it has a very profitable portfolio company, it could choose to hold on to it for 10 years. “If times are not good we can keep the company for longer”.

The firm normally puts in between 50-60% of debt in financing buyout deals. According to Private Equity C, they are not prepared to incur a higher risk that higher gearing brings. However, it uses debt in finance in order to reduce its own investment, thus creating higher ROI.

Private Equity C owns between 60-80% in its portfolio companies while management and the former owner have an ownership of 20-40%. The firm recognizes that the former owners have a lot of industry knowledge and valuable information. “They know so much more about the company than we do”. Therefore, the firm strives to keep old owners on board and to create smooth transaction of ownership. “The old owner can say to the employees: I found a new partner”.

To finance buyout transactions, Private Equity C only use senior debt. The firm explains that subordinated debt such as mezzanine is a more expensive form of financing. In addition, it typically does not embark on a high leverage and thus, does not need mezzanine financing.
Private Equity C also rejects the use of securitization as a means to finance an acquisition. “In our minds, it would be a zero cum game”. The firm argues that securitization reduces the value of the portfolio company’s balance sheet. The lender would then be inclined to give it less senior debt and hence, less gearing. Further, securitization of assets and reduction of equity financing increases financial risk more than what the firm is willing to bear.

**Active ownership**

*Network of experts and Board of directors*

One of the primary actions is the appointment of a new board of directors. “That is something we do very early”. Typically the board consists of 4-5 people: 3-4 from Private Equity C and 1-2 previous owners. The board includes industrial advisors from the firm’s network. “We use their experience on the board”. These advisers usually participate in the acquisition process as well as the due-diligence process. Board meetings are held once a month at the beginning and thereafter less frequent.

By setting targets and constantly following up, the board puts pressure on the management. “If the CEO knows he has a board and owners who ask questions, he will make sure that the people in the organisation also would stand on their toes”. Moreover, the firm is able to evaluate what it has done wrong and what can be improved if the targets are not reached.

**Management team**

Private Equity C seeks for companies with a strong management team as it prefers to keep the current management team. According to the firm it is always possible to replace management, but it may take a lot of time. Moreover the firm argues that it may also be hard to find a good and experienced management that is willing to take on smaller companies.

**Reporting and key performance indicators**

Private Equity C expects monthly financial reports from the portfolio companies. In addition, every quarter, the CEOs of the portfolio companies put together a report of the last 3 months. This report includes the activities, financials, business prospects, and market trends for the coming quarter. This report is thereafter sent out to all the shareholders of Private Equity C. The firm also uses several KPIs for keeping track of the company such as sales growth, margin expansion, and cost control. However it tries to take “more of a long term view” and therefore not focus so much on short term indicators.

**Incentive program**

In order to incentivize management, Private Equity C offers option programs. Managers are also required to invest some of their own money in the company, so the interests of the managers are aligned with those of Private Equity C. The firm does not set a minimum amount to be invested by managers. However it is good if the amount they invest matters to them “if you put in 10 SEK, you don’t care…but if you put 50,000 it does matter”. The options and shares are normally offered only to top management “who are the key people in the company?” The firm can also offer bonuses to, for example, sales managers if they reach specific targets.

The incentive programs are very specific to each company, depending on the structure of the management and the activities of the company. Sale persons are more likely to receive bonuses than managers. Also if the option programs are attractive to the management, then
the bonuses are not really needed. Managers cannot sell their part of the investment nor the options before the firm sells its part of the ownership. “It is illiquid”.

**Experience sharing**

Private Equity C gathers its portfolio companies and encourages them to share knowledge and experience. “We are trying to share experiences between the companies”. The CEOs of the portfolio companies and other managers meet for a “weekend of exchanging experience”.

**Operational improvements**

Private Equity C only invests in companies operating in the industries which the firm has knowledge and experience about. ”We really believe that you need to know the business you invest in”. The firm also has few industrial advisors who work on a formal basis and know the industries it invests in. Having the right industry knowledge enables the firm to understand and contribute to the operation of the companies. The firm normally evaluates the cash flow generation, cost structure, margins and efficiency of the companies. The firm evaluates whether margins can increase when increasing the prices of the products or whether the cost of doing so is higher. The firm does not normally focus on cost cutting “we are more trying to continue growing the companies”.

Private Equity C looks at the different components of their companies and sets targets, normally benchmarking with other companies in the industry, for each individual component to evaluate how it can be improved. In order to set targets, the firm must know that the controlling system functions properly. Very often, there is a lack of focus on this part in the companies that Private Equity C acquires. They usually lack a controlling person who sets up certain key targets and key values. “Often we need to strengthen the controlling functioning”. The firm needs a controller that can set key targets and key values that are forward looking. According to Private Equity C, small family businesses often put little resources to cash management and “do not push that hard” to increase the percentage of earnings, something that the firm is very keen on changing.

Private Equity C then evaluates the companies’ inventory handling and whether it can be improved. The firm also looks at the sale force of its portfolio companies. Many of the companies Private Equity C owns have a large sale force. According to the firm it is often the case that there are no clear and demanding targets “we are a little bit more demanding”. The firm’s analysis is that: as long as the companies have performed reasonably well, the former managers have not been that tough on the sales force. Thereafter the firm looks for potential improvements by going through the company function by function.

**Strategy**

Private Equity C is not keen on engaging in turnarounds and structural changes. Even though the firm realizes that the returns can be much higher when buying a company in financial distress at a low multiple, turning it around and selling it at a higher multiple, “the risk is much higher”. According to the firm, the cash flow generated by these types of companies is not sufficient for further investment and therefore the owners may have to provide more equity.

The firm seeks to develop the strategy of the companies but not changing it entirely. It looks to sharpen the focus of its portfolio companies. Private Equity C also focuses on performance and efficiency. “We focus on improving the industrial and financial performance of companies” “just being more efficient”.

36
Private Equity C finds it important to have a long term view for the portfolio companies. As explained by the firm a lot of changes need to be implemented at the start of the ownership. When implementing several strategic, structural and operational changes at the same time within a company, figures might not look so good for a couple of quarters. Also when a company is being acquired, it takes up a lot of the management’s time. Therefore management team might not be as efficient in their work as they normally are. “We realise that all companies go through difficult phases”.

Private Equity C prefers not to engage in add-on acquisitions. “We prefer to find a business that we do not have to do it”. So far the firm has had few cases in which it did add-on acquisitions. It recognizes that it takes a lot of resources. “It takes time, it takes resources, it takes focus”, and it is often “hard to create the right synergies” that will benefit the company and add values to it. According to the firm, it would be easier if a big portfolio company could acquire a small company as an add-on but usually the portfolio companies that Private Equity C owns are quite small.

**Timeframe**

Private Equity C recognizes that larger changes should be done as soon as possible “to get the ball rolling” and to “reduce insecurity in the business”. The firm evaluates the controlling system. “It's important to get the numbers right as soon as possible”. According to the firm, it is hard to get the company towards targets without an appropriate controlling function. The selection of board members has also a top priority “that is something we do very early...even before we reach exclusivity”. Then it is important to establish a good relationship with management. “You also need to gather everyone around to show that you are not just an anonymous investor”. If there is a need to make changes in management it should also be done early in the investment.

### 5.4 Private Equity D

Private Equity D focuses on buyouts in mature and established companies, operating in mature industries, with financial problems. The firm specializes in managing and financing companies that require a turnaround “our expertise is turnaround, how you manage a process of change”. These companies are often independent companies. The firm does not seek to acquire divisions from larger corporations. Private Equity D normally seeks to co-invest with individuals who have particular industry knowledge in the segment they are willing to enter. The firm currently has two funds and it have invested in 12 projects since its start.

**Investment criteria**

Private Equity D seeks for established companies with financial difficulties. According to the firm, the scope of this criterion is subjective and hard to define. Its view is that somehow, the companies have turned into the wrong track and in order to get back on the right track additional capital is needed. This is what Private Equity D refers to as a turnaround situation.

Ideally, the potential companies should have gone through some business cycles, so they have reached a critical mass. These companies should have a great growth potential over a short period of time. This growth potential is often the ability to transform a business, facing difficulties, into a healthy business. Before any investment, the firm asks itself whether it is possible to make a turnaround of the potential acquisition, using the firm’s resources. If the answer is positive, Private Equity D will be interested in investing.
Portfolio companies are often recommended by banks to contact Private Equity D when they are in a need for financing. The scenario might be that the bank has set lower borrowing limits to the companies, or refuses to uphold current loans. This may occur when the companies present "bad numbers", have little capital on their own and show negative cash flow.

**Deal structuring**

Private Equity D’s holding period is usually between 1-3 years, which is the time required to make the turnaround. The firm does not intend to hold companies for a longer period, after it finishes with the turnaround. Private Equity D believes that all companies should be in a constant state of development and if the firm cannot develop a portfolio company further, it should be sold. However, in some cases the firm holds the portfolio companies for a longer period until the right sale opportunity arises. The exit depends on the market. The firm assess whether it is the right time to sell the company.

Private Equity D is reluctant to use debt in financing new projects. The firm’s reasons for excluding debt relates back to its founding. The business idea of turnaround was new and uncharted. It was decided that only the firm’s equity would be put at risk. This was a strategic decision by the firm’s owners and its CEO, and it has characterized the business model even since. Private Equity D claims that the financial positions of its portfolio companies did not affect the decision of whether to use debt. During recent years, Private Equity D has received proposals from several large banks to leverage its investments. However the firm has declined these proposals, but it does not exclude the possibility of debt financing in the future.

**Active ownership**

*Network of experts and board of directors*

Private Equity D always acquires the majority of its portfolio companies. The size of its share in a company can differ from case to case. However it is important for the firm to hold more than 50%, the rest is distributed between management and previous owners. As the company is in a turnaround situation and the firm wants to be able to take final decisions “we must be able to choose path in this critical phase...we have to have one who decides which road we should take”.

The firm exercises its active ownership by taking a sit on the board of directors. Normally, the board of directors consists of one person from Private Equity D, one external chairman and 2-3 persons from the previous board. The firm recognizes the importance of keeping representatives from the previous board as they hold valuable knowledge about the company and the industry “if you want to be able to form the company’s future, you must know its past”. The firm normally seek to co-invest with outside investor(s) who possess the relevant industry knowledge that Private Equity D might lack. It is the co-investor that usually takes on the role of chairman. With relevant industry knowledge the chairman acts as the link between the board and the management. Initially the board meets at least once a month and have more constant phone contact. The board also keeps a very close relationship with the managers, monitoring them to ensure that they follow through.

Private Equity D advocates a relatively small board of directors. As argued by the firm the company is in a turnaround situation and thus experiences a state of continuous change, where speed, flexibility and accuracy of decisions are vital. By keeping the board small, “you have short and efficient decision-making process”. There is no fixed number of board members,
but the firm stresses that the board should not be bigger than what is absolutely necessary to go through with the turnaround.

**Management team**

Private Equity D acknowledges the importance of having a management team with strong competence. If the current management lacks sufficient competence, the firm may change its structure. However, the firm prefers to keep current management and to make as little changes as possible "we have done as few changes as possible…none of us believes in revolutions".

**Reporting and performance indicators**

The management team is required to hand in written financial reports to the board of the company containing several KPI’s such as sales and margins on sales.

**Incentive program**

Privet Equity D always requires managers to co-invest in the company. In addition the firm offer managers different option programs and bonuses in order to motivate them to increase the performance.

**Operational improvements**

Private Equity D observes the way their portfolio companies operate. The firm spend time with the companies on the work floor to see how they work within the different departments. This method enables the firm to learn the processes and the companies’ way of doing business. According to the firm, it is easier to work with financial problems if you are able to visualise them. It makes it easier put focus on if you really understand the processes involved.

The firm usually uses its network to support portfolio companies in different areas, such as negotiation with suppliers and banks. In addition, it evaluates the operating efficiency and the profitability of customers and products. The firm tries to define the core of the companies and it might divest or outsource non-core operations.

Private Equity D normally helps its portfolio companies with legal and financial advices. Since the portfolio companies it acquires have financial difficulties, the capital management has not always been handled properly. This problem is often solved by the firm bringing in its own people on a consulting basis to strengthen up the capital management within the company. Private Equity D also recognizes a need of strengthening the supply chain management within most of its portfolio firms.

**Strategy**

Private Equity D normally maintains the current strategy of the firm and in some cases only slightly modifies it. Instead, it strives to only change the absolutely necessary "if you change very much you don’t know where you end up". According to the firm, the current entrepreneur and management usually have a good strategy and a good picture of what is needed to be done. However, they might lack the financial resources to do it "they have a clear picture of what should be done, but they lack the financial resources to fulfil their goals".

Private Equity D recognizes the potential gains with doing add-on acquisitions, gaining a higher multiple as the company grows stronger. However, in general, the firm is very prudent in these scenarios "you should stick to what you know". The firm recognizes that it is hard to realize all the potential synergies from add-on acquisitions since its ownership period for
its companies is very short. However, the firm has done few add-on acquisitions, but these were not part of the turnaround. Instead, the opportunities appeared afterwards.

The firm mentioned a scenario it was facing with one of its portfolio companies. The initial purpose of the acquisition has been fulfilled as the company has gone through a turnaround and became profitable. However, Private Equity D saw further potential for growth in this company. The firm saw the opportunity to grow the company larger through add-on acquisitions. Although it deviates from the core operation of Private Equity D, the firm saw the opportunity to attain greater gains.

**Timeframe**

Private Equity D starts by changing the structure of the board. Then it looks into the capital management of the companies and tries to make it more efficient. The firm normally does a list of actions that needed to be taken. A document specifies the time frame in which these actions needed to be taken and the resources required to manage these actions. This list is continually being checked, and a monthly progress report is sent to the firm.

**5.5 Private Equity E**

Private Equity E focuses on growing small and medium-sized companies in the Nordic region, primarily Swedish privately held companies. The investment opportunity for the firm arises as a result of either generation shift or streamlining of a business (i.e., divestments of divisions by large corporations). Investments are open to all industries, except for those which imply high fixed costs (e.g., infrastructure construction), trading companies where the competitive advantage and the market position are often unclear, and consulting companies where profits are difficult to be preserved.

**Investment criteria**

When evaluating potential investments, the management team and the market position possessed by the companies are the most important qualities for Private Equity E to consider. The firm finds it particularly attractive if the target company has a strong management team and holds a market leader position in the industry. Also, the company should ideally have a potential of doubling profits over 4-5 years and a turnover exceeding 100 million SEK. Other investment criteria include cash flow and cash conversion ratio. “The cash flow is obviously important. Since we do leveraged buyouts, you will need the cash flow to support the debt you take on”. The cash conversion ratio reveals the proportion of profits relative to the proceeds from the future sale of the portfolio company, taking into account the possible investments made in inventory, fixed assets, etc.

Private Equity E only looks for further development of already profitable companies and never does a turnaround. According to the firm, buying a market leader is obviously expensive but “if you are then skilled in maintaining it and perhaps expanding that position, you will get even more when you sell it”.

**Deal structuring**

Private Equity E’s holding period is usually between 4-5 years. However, the firm sometimes sells the portfolio company earlier than intended if the business plan has been successfully implemented. “You sell it when you have a good opportunity. The company is performing well and the market is performing well”. 
To finance the buyout deal, Private Equity E employs a considerable amount of debt. The portion of debt used depends on the kind of the industry, the stability of the portfolio company, the cash conversion ratio, the investment plan, and the kind of security the bank gives. It is necessary for Private Equity E to estimate in advance the total financing needed for investments in plant, property and the business as a whole. Based on this estimation, the firm determines how much money should be financed by bank loans, taking a 5-year view. It then depends on the bank to decide what the proportion of debt can be given. In general, the bank will grant Private Equity E 50-60% debt out of the total deal value.

Private Equity E affirms that the use of leverage forces managers to be more efficient in cash management. If the portfolio company is previously part of a global group, it could have a cash management program internally. If it is a family company, the owner may sometimes spend money on private uses. With debt, “cash becomes a scarce resource. Management is very motivated not to have a bad discussion with the bank.”

Active ownership

Network of experts and board of directors

Private Equity E has access to a close and active network of industrialists with operating experience in various industries. The members of the network hold or have held Executive and Management positions in large Swedish or international corporations.

The firm exercises its active ownership by taking a sit on the board of directors. Private Equity E often holds up to 70-85% of the equity ownership in the portfolio companies and the rest is distributed between the previous owner(s) and the management team. Being a majority owner, the firm restructures the board. Private Equity E prefers keeping the board small. “5 is a good number”. It typically brings in two representatives from the firm, an external chairman, and two industry experts with relevant experience and knowledge for a particular industry. “It should be a pretty small and effective board”. The experts can be sought from the firm’s existing network. If the industry is new to the firm, it will look for new industrialists. The network can be expanded on a daily basis. The management is never on the board.

Private Equity E sometimes welcomes the previous owners to co-invest with it if they still want to add value to the company. The firm tries to keep them motivated since they have lot of contacts with, for example, customers.

The firm sees the advantage of having a small board as accelerating the decision making process. In addition, the board of portfolio companies usually represents the only stakeholder, implying almost no fighting and conflicting interests. Therefore, the board can concentrate on growing the business. “This is very much oriented or with full focus on developing the company”. The disadvantage perceived by Private Equity E is narrower types of industrial experience.

At the beginning of the investment period, the board meets frequently, roughly every month. In the later periods, the meetings may take place once each quarter. There are often 4-6 scheduled meetings but there will be a lot of conferencing on the phone.

Business plan

“What we want to do is to build a business plan that is realistic and takes the company to a higher level during our business”. When Private Equity E makes a business plan, it develops several cases: a base case, which focuses on small changes, and an expanded case where the firm may pursue some add-on acquisitions.
Management team

There are always changes in the structure of the management team. When there is a generation shift, the old owner or founder that had previously led the company wants to leave his positions. The firm then needs to find a new top management.

Reporting and performance indicators

Private Equity E demands a monthly report to be handed in by the management. The type of information provided in the report varies. It not only includes financial accounting information but also management accounts. Private Equity E sometimes resorts to professional consultants to build the report together with the management. According to the firm, “it [the report] does give you better information about where to start chasing money”. In one case, the firm was able to free up resources by outsourcing 30% of the business given the information reported for the portfolio company’s factory.

To track the company’s performance, Private Equity E pays attention to ordering intake, sales, and gross profits. The firm also looks at what kind of covenants the company has with the bank when it takes on debt and constantly checks if the company is following the covenants.

Incentive program

The management team is required to hold 10-15% of the equity ownership in the company. “It would be a very bad thing if the old management refuses”.

Further, Private Equity E offers the management an option package. “If they do exceptionally well, they will get a larger share of the cake”. The options allow managers to buy the company’s shares at a highly favorable price that they may not be able to afford at a normal market price. “It makes them happy to switch to options, which may take the cost [of buying shares] down”. From Private Equity E’s viewpoint, the advantage of the option program is that it creates a downside for managers. If they do not perform well, they will also lose their money. Further, the management is not allowed to sell their shares until the firm sells the company. “In general they can’t dispose of the share until we sell”.

The option program is not limited to the CEOs. Other senior managers may participate in the program as well, depending on the configuration of the company. If there are important business area managers or country managers, R& D boards or factory boards, they are all invited but with a smaller stake.

Operational improvements

When working on operational improvements, Private Equity E particularly focuses on supply chain management. “That is very much an area where we do make improvements”. Supply chain improvements often concern with the decision of “make” or “buy”. The firm is confronted with the question of whether the portfolio company should manufacture things itself or buy from other suppliers. Outsourcing helps reduce production costs. To assist the portfolio company, Private Equity E brings in a supply manager or a board member who has tremendous experience in this area.
Strategy

Private Equity E rarely changes the whole business strategy of its portfolio companies because it may be exposed to a much higher risk. “What we want to do is to take successful companies, basically do more of the same but perhaps with some added twists.”

Divestments of product lines are not common in Private Equity E’s portfolio companies. The firm explains that it is more common in large buyouts, where the target companies have many business lines. Meanwhile, most of its portfolio companies are relatively small.

The firm is supportive of add-on acquisitions. “Add-on acquisition is a good thing to add value to companies if you do it right and if you buy the right thing for the right price”. An issue pointed out by the firm is how add-on acquisitions must be financed, whether they should be financed with the cash flow from the company itself, with bank loans, or a combination of these. Another issue is that it takes a long time, up to 12-24 months before the operations of both companies are fully integrated and the synergies are really found. In order to get a full payment for that work, Private Equity E usually plans to make acquisitions ahead and do it within the first 12 or 24 months. “If you want to make acquisitions, make them early on”.

Private Equity E cited several benefits of add-on acquisitions. First, it leads to cost-cutting. Instead of having two managing directors, one managing director can now monitor a bigger company. Second, the company expands its operation to other geographic areas of interest. Third, increasing the size of the company attracts a higher exit multiple. Lastly, add-on acquisitions may be induced by the allocation of profits in the value chain though this is not common. For instance, the company is currently in the manufacturing industry, where the margin is quite low compared to distribution or retailing businesses. In such case, it may consider entering in those more profitable segments of the market by acquiring other companies. However, “the rationale for doing this [add-on acquisitions] is always you want to cut costs and everything else is just bonus”.

When working with the strategy, Private Equity E takes a long-term view and ensures that managers do not pursue short-term goals. “As the board and management, we are not worried about short term profits” as long as these are what need to be done. However, the company is subject to the covenants with the bank when it takes on debts. Private Equity E will then have a dialogue with the bank. Having understood the possibility of profit drops due to significant changes, the bank may adjust the covenants accordingly.

Timeframe

Private Equity E does not follow a standard time frame across all buyout transactions. “It is more adaptive to a particular company and the business plan”. However, the board of directors can be taken as the first step. A business plan needs to be crafted early. Other things that the firm is likely to do include putting the management into place, following up and performing due diligence, searching for consulting, identifying certain areas that must be addressed immediately. Yet, what these areas are varies from case to case. There is no single blueprint for the first and each subsequent month.
6 Analysis

In this section, the empirical findings gathered from the interviews will be analyzed with the help of the theories presented in the theoretical framework.

The empirical findings give the overall impression that all private equity firms in the study exert an active ownership in their portfolio companies. The need to adopt a hands-on approach derives from the small gains generated by debt financing and the difficulties associated with multiple arbitrages.

As explained by Private Equity B, private equity firms can generate returns in three ways, either through leverage effect, multiple arbitrages, and operational improvements. The leverage effect is attainable through the use of debt in financing buyout transactions. Adopting this strategy, a private equity firm employs a high leverage to acquire the target company and pay off debt using the company’s cash flow throughout the investment horizon. Since debt is a much lower cost of financing compared to equity, the firm is able to enhance its equity value significantly as the company gradually amortizes the debt. A dramatic increase in equity value results in excessive returns upon the sale of the portfolio companies. With multiple arbitrages, a private equity firm typically acquires a company in an industry downturn paying a low multiple and sells it in an upturn at a higher multiple. Using this strategy, the firm makes profits without adding any value to its portfolio company.

To illustrate the difficulties of making gains through leverage and multiple expansion, Private Equity A reported to earn, on average, a low return of 14% through debt financing and a negative gain of -7% through multiple on all the investments it had made in the past. In many cases, the firm acquired a company in an industry upturn and sold it in a downturn. Private Equity C also expressed its concern with multiple arbitrages. According to the firm, interest rate and industry prospect are two factors, which affect the probability of making gains through multiple arbitrages in the future. However, it proves difficult to predict the move of interest rate and the industry outlook few years ahead.

Recognizing the small gains by debt financing and the uncertainty of multiple arbitrages, private equity firms in our study actively improve the operation of their portfolio companies as a main way to generate returns. This practice is consistent with the prediction by Wright et al. (2006) that private equity firms will have to increasingly differentiate themselves through operating capabilities.

Before discussing the value adding methods used by the five private equity firms, their investment criteria and characteristics of target companies will be reviewed briefly.

6.1 Target companies and Investment criteria

All private equity firms in this study focus on growing small to medium-sized companies. Private Equity B and E seek for investment opportunities that arise as a result of either generation shift in family businesses or divestment of non-core businesses by large corporations. Meanwhile, Private Equity A mainly concentrates on acquiring non-core divisions from big groups and Private Equity C has so far looked to invest in family businesses. Following an utterly different track, Private Equity D invests in small companies with financial difficulty.

While scanning companies for potential acquisitions, four out of five private equity firms rely on a set of similar criteria. The target companies are expected to hold strong market
position in a well-defined niche, possess a strong management team, and have the capability to generate steady cash flow. A similarity among these private equity firms is that they all invest in already profitable companies and do not seek to make turnarounds. Unlike the four firms, Private Equity D concentrates on companies that are in financial difficulty and require a turnaround. Therefore, the firm also emphasizes the importance of partnering with a good management team but finds it irrelevant to look at the cash flow. Further, Private Equity D does not resort to debt in acquiring the target companies. On the other hand, the four other firms use high leverage in financing buyout transactions and thus, perceive the stability of cash flow to be crucial. In order to repay the debt, it is essential that portfolio companies are able to produce good cash flow.

The difference in investment criteria between Private Equity D and four other firms implies that private equity firms’ expectation of target companies varies slightly, depending on the type of companies acquired and on how the firms plan to finance the transactions.

### 6.2 Governance Engineering

**Board of directors**

*Size and Structure of the Board*

The first step taken by all private equity firms in this study is to restructure the board of the portfolio companies. The board always consists of representatives from the private equity firms and industry experts. The appointment of the firms’ representatives to sit on the board corresponds to the study by Rogers et al. (2002). The involvement of industrialists in the board of directors is consistent with Kaplan’s viewpoint (Jensen et al., 2006). Industry experts with relevant experience and knowledge are considered by the five firms to be the greatest resource that they can bring to their portfolio companies.

Although private equity firms’ representatives and industry advisors are indispensable components of all boards, the specific structure of each board varies among the studied firms. Jensen observes that the board is often made up of representative(s) from private equity firms and the portfolio company’s largest shareholders (Jensen et al., 2006). However, this is not always the case for private equity firms in this study. Of the five interviewed firms, three often seek to co-invest with the company’s previous owners. In these cases, the board also includes representative(s) of the previous owner(s) or the previous owner(s) themselves. Meanwhile, Private Equity A and B do not involve any old owners on the board. The difference in the configuration of the board can be explained by the ownership structure post-buyout transaction. Private Equity A and B often hold up to 90% of the acquired companies and the residual ownership is allotted to the management. The three other private equity firms, however, own smaller proportion of their portfolio companies (60-80% for Private Equity C, 75-80% for Private Equity E and slightly above 50% for Private Equity D). In those cases, there is equity stake to be distributed between the previous owner(s) and the management.

The presence of previous owners on the board is advocated by the three private equity firms for several reasons. According to Private Equity C and D, the old owners possess valuable knowledge of the business and its people. Private Equity E adds that the previous owners help the business maintain a wide network of contacts (e.g., with customers) established earlier.
Despite some differences, a common feature of all boards is that they are totally independent of management, which coincides with the study by Millson & Ward (2005). In their study, 27 buyout experts affirm that private equity firms find it crucial to have non-executive board.

Another characteristic is that the size of the board is kept relatively small by all studied firms, between 5-7 persons. The five firms in the study acknowledge the advantage of having a small board as accelerating the decision-making. As explained by Private Equity A, B and E, their boards represent virtually one sole owner. There is much less conflict and disagreement among the board members. Therefore, the decision-making process is less bureaucratic and politic. The small size of the board and the advantage associated with it exactly match Jensen’s observation (Jensen et al., 2006). However, this advantage is unclear if private equity firms acquire small companies where the board may be already small, or acquire family businesses where the owner has the sole authority to make decisions.

**Board meetings and contact with the management**

All private equity firms in the study reported to have regular board meetings during the initial period of investments, roughly once a month in the first year. The frequency of board meetings derives from the need to build rapport with the management and to implement many fundamental changes within this period. In the subsequent years, the meetings are held less frequently. However, there is lots of contact in between among board members.

Moreover, the five firms claim that their boards maintain a close contact with the management. The board of Private Equity A and B meets with the management at least once a week, which is more frequent than Feldberg’s suggestion. Feldberg observes that the directors of the board meet with the CEO and other members of the management every couple of weeks for years (Jensen et al., 2006).

Jensen supports a close contact between the board and the management as a way to keep the specific knowledge of the business staying up to date (Jensen et al., 2006). As a result, the information gap, which is the root of the principal-agent problem, is minimized. Although such a relationship does help private equity firms in our study develop their knowledge of the business, whether it helps create value by mitigating the principal-agent is less obvious. If the portfolio companies are family businesses such as those acquired by Private Equity B, C and E, the owner is often the manager. In such cases, the principal-agent will not be present prior to the acquisition by these private equity firms.

Nevertheless, the constant follow-up by the board is believed by the studied firms to serve as an effective control of managers. According to Private Equity C, the permanent presence of the board discourages managers from engaging in self-interested activities, knowing that their actions are closely watched by the board members. Private Equity A adds that frequent meetings with management keep up a high momentum among board members and managers, create a sense of urgency, and foster managers to constantly and actively implement changes; thereby, speed up the change process.

Of equal importance is the type of discussions taking place during the board meetings. Private Equity A and B recognize the ability of its board to focus on the business as the key success factor. As explained by the two firms, their acquired companies were non-core businesses of large corporations. While being owned by the big groups, those companies were often given too little time to discuss their business during the board meetings. Under the governance system of private equity firms, the companies have their own boards and are given full attention throughout the meetings. These boards only focus on the business
and operational issues, something that Jensen does not observe in the public board meetings (Jensen et al., 2006). This implies that portfolio companies receive considerable assistance from the board to more effectively resolve business issues or to initiate new ideas under the management of Private Equity A and B. However, this value-creation element is perhaps more obvious in these two firms where the acquired companies were previously ignored by the big groups. For Private Equity C, D and E who target independent small companies and family businesses, such a problem is unlikely to be present before the acquisition.

Management team

All studied firms search for companies that possess a strong management team and prefer to make as little change in the management as possible. While assessing managers, Private Equity B emphasizes their capability to take a high tempo. Due to the limited investment horizon of private equity investments, significant changes must be implemented and multiple actions need to be undertaken simultaneously. Therefore, managers are demanded to be highly capable of working in a fast motion and under high pressure.

If there is a change in the management, the type of change is usually to bring in additional personnel. Private Equity A, for example, often adds a CFO and a COO to the management team. Its portfolio companies usually did not have their own finance function when they belonged to the big groups. Hence a new CFO is needed. Moreover, a COO will be appointed to the team since the firm often plans to expand the operation of its portfolio companies. Likewise, Private Equity E many times brings in a supply chain manager as it seeks to improve the supply chain of the portfolio companies. Recognizing the need to put more pressure on the staff force, Private Equity B often appoints a controller capable of setting key targets that are more demanding for the company. In doing so, it strengthens the controlling function.

Replacement of management can also occur for various reasons. According to Private Equity E, a new top manager is always sought when there is a generation shift in a family business and the previous owner wishes to leave his position. Another reason cited by Private Equity A is that the portfolio companies enter into different phases of development, which requires distinctive skills possessed by different types of managers.

Due diligence

Heel & Kehoe (2005) reveal that the best-performing deal partners in their study devote half of their time to learn about the company and its management at the early stage of the investment. Consistent with their findings, the five firms perform the due diligence in the acquisition process and frequently interact with the management throughout the investment horizon, particularly within the first year. To ensure a proper due diligence, all firms involve industry experts in the acquisition. These experts possess in-depth industry knowledge, which assure the private equity firms a thorough understanding of the businesses that they seek to invest in.

Reporting and Key Performance Indicators (KPIs)

Managers of portfolio companies are required by all studied firms to submit detailed monthly reports. Private Equity E, for example, demands monthly reports to include both financial information and management accounts. Likewise, Private Equity C carefully examines cost structure and cost control. Such a high need for access to monthly reports and
management accounts by the studied firms coincides with the study by Millson & Ward (2005).

The five firms also establish a set of KPIs, which cover various aspects of the business. This contradicts with the findings by Rogers et al. (2002), in which private equity firms in their study had a strong preference for cash flow ratio and ROIC. Private Equity A, for example, places equal importance on financial and non-financial indicators. The firm finds it crucial to examine non-financial information, such as the number of clients gained and lost, change in average purchase value per customer. Private Equity B looks at operational improvements, cash flow as well as liquidity development. Others emphasize sales and margin growth. Rogers et al (2002) argue that private equity firms focus on few indicators as a board array of measures complicates the discussion and impede actions. However, private equity firms in this study find a need to examine a variety of indicators. As explained by Private Equity A and C, the two firms seek to constantly improve the performance of their portfolio companies. The use of various indicators allows them not only to track the performance against the targets (internal benchmarking) but also to spot new development trends and to identify opportunity for efficiency enhancement.

Incentive mechanism

Heel & Kehoe (2005) find out that the best performing deal partners in their study established a performance-based incentive program and required managers to make significant investment in the business. Corresponding to their findings, all private equity firms in this study adopt a “carrot and whip” approach that aims at motivating managers. First, managers are always required to purchase an ownership stake in the company. They are then given additional incentives through option or similar programs. All studied firms do not set a standard equity amount to be held by managers. For Private Equity C, management’s ownership participation ranges between 5-10%. Meanwhile, Private Equity B generally requires managers to hold between 10-15%. The precise ownership proportion held by managers indeed varies across portfolio companies. Possible explanations for these variances are the management’s financial capacity to participate and the size of the deal.

All studied firms agree that such a “carrot and whip approach” creates both upside and downside for managers and thus, better aligns the interest of managers with that of the owners. Managers get a larger share of the cake if they perform well but run the risk of losing their own money if they do not. Therefore, they are highly motivated to run the company more efficiently. The five firms’ viewpoint coincides with Kaplan’s explanation of the rationale behind this approach (Jensen et al., 2006). Private Equity A further emphasizes managers’ willingness to co-invest as an indication of the management’s belief in their own plan.

Although options are the most common form of incentives, cash bonus can also be given. Private Equity B, however, says that the compensation package depends on the type of jobs people do. For example, sale persons are likely to receive bonuses than managers.

The five firms also claim that the incentive programs are not restricted to the CEO, which corresponds to Moont’s suggestion (Jensen et al., 2006). Private Equity B and E explain that the scope of the programs is determined by the configuration of the organisation. If the company has a number of branch managers, for instance, there can be up to 50-60 people taking a part in the program. However, these managers will receive a smaller stake.

None of the private equity firms in the study allow managers to sell their equity stake until the firms exit the portfolio companies. Making management’s equity illiquid coincides with
Kaplan’s proposal that managers should not be able to sell stocks until the increased value is proved (Jensen et al., 2006).

Although equity grant is an effective tool to closely tie managers’ interest with the interest of the owners, whether private equity firms have added values to their portfolio companies using this mechanism is not apparent. The fundamental of equity grant is to make managers become owners and thereby, resolve potential conflicts between these two agents. However, the problem of conflicting interests is unlikely to be present in family businesses, where the owners are often the managers. For the case of portfolio companies that used to be parts of the big groups, managers of the acquired divisions may already have equity ownership under the governance system of the large corporations. In these instances, the use of equity-related mechanism does not necessarily lead to value creation. The possibility to better align the management’s interest exists only if managers previously held a pretty small stake of the large corporations, which was insufficient to encourage a better performance. In view of these considerations, the “carrot and whip approach” is more likely to strengthen corporate governance of portfolio companies if the companies used to be non-family businesses or if managers used to hold an insignificant equity ownership of the big groups.

6.3 Financial Engineering

Debt financing

According to Wright et al. (2006), leveraged buyouts are typically characterized by the use of high leverage. Zong (2005) further reveals that private equity firms often use approximately 60% to finance buyouts. Except for Private Equity D, four other firms employ between 50-70% debts in structuring the deals. Private Equity B can go as high as 75% in some cases. Although these firms do not explain specifically why they come up with such numbers, the use of high leverage likely links to the type of companies acquired. These four firms target already profitable companies with good and stable cash flow, which guarantees that debts can be paid back within the investment horizon.

In contrast, Private Equity D never resorts to debt in buyout investments. The firm claims that the exclusion of debt does not relate to the type of companies acquired. Rather, it has been an investment philosophy adopted by Private Equity D since its foundation. However, its explanation is not well justified. As demonstrated earlier, levering a buyout allows a private equity firm to accelerate its equity value significantly when the portfolio company gradually amortizes the debt. If it were not because of the acquired companies usually in financial difficulty, making the investments highly risky, there should be no other reason why Private Equity D does not make use of debt in order to yield the highest possible return. Another possible reason may concern the portfolio companies’ ability to amortize debt. Since they are already in financial difficulty, the cash flow is unlikely to be sufficient for debt repayment during the early years of the investment. If these are not the cases, Private Equity D has not earned optimal returns by excluding debt in deal structure.

Although the type of target companies plays a role in deal structuring, there are additional factors that lay the ground for private equity firms in determining the debt ratio. Pinegar & Wilbritch (1989) suggest a number of factors to be considered, including the predictability and stability of cash flow, dilution of company’s equity claim, liquidity of the company’s assets, loss of financial flexibility, corporate tax rate and increase in operating risk. While the stability of future cash flow is an important determinant for Private Equity A, Private Eq-
uity C places a great emphasis on its risk-aversion. Private Equity C normally does not use more than 60% debt. As explained by the firm, it is not prepared to incur higher risk. Although the stability of portfolio companies is also considered to be crucial by Private Equity E, the firm looks more into external other than internal elements proposed by Pinegar & Wilbritch (1989). Examples of these are the kind of the industry in which the company is operating, the cash conversion ratio, and the investment plan. Such focus on external factors infers that the high leverage generally does not create liquidity problem, financial inflexibility and significant operating risk for their portfolio companies.

The rationale behind the use of high leverage is first to generate return on investment through leverage effect, which is discussed earlier. Damodaran (2001) argues that increasing the proportion of debt in a company’s capital structure leads to a lower cost of capital and thus, a higher firm value when calculated using valuation models. Although debt is agreed to be cheaper than equity financing, private equity firms employ debt as a means to augment their equity value along the subsequent amortization of debt rather than to lever the portfolio company’s value as discussed by Damodaran (2001).

Nevertheless, Private Equity A, B, and E acknowledge the role of debt as to impose pressure on managers in managing capital more efficiently. These firms often target well-established and mature companies, which, according to Eun & Resnick (2007), tend to suffer from the “free cash flow” problem. While it is true that their acquired companies do not make use of their cash, the cause of the inefficiency differs from Jensen (1986)’s explanation. Jensen (1986) argues that managers of cash-rich companies are tempted to retain and waste cash on unprofitable projects. However, the inference from the studied firms’ explanation is that the free cash flow inherent in their portfolio companies has its root from the organizational structure itself rather than from managers’ initiative. According to Private Equity A and B, divisions that used to be parts of big groups usually do not find the need to manage capital efficiently. If they are in lack of capital, they can call for help from the parent companies. In those divisions, the free cash flow takes the form of either idle cash or cash tied up in working capital. If it is a family business, the owner has the total right to the cash generated by his company and may spend it on personal uses, as pointed out by Private Equity E. To a certain extent, the private equity firms believe that debt motivates managers to be more efficient in capital management.

Debt instrument

The most common debt instrument used by private equity firms in the study (excluding Private Equity D) is senior debt. Their main concern is the price of subordinated debt, which is, according to Private Equity A, B and C, much more expensive than senior debt. Private Equity A, however, sometimes uses mezzanine debt or vendor loan. As it explained, the deal structure is determined by the transaction value and the senior debt amount that the bank is willing to lend other than by the firm itself. If there is any gap after using up all equity and granted senior debt, Private Equity A may resort to subordinated debt to bridge the unfinanced portion.

The use of subordinated debt is argued by Wright et al. (2006) as to leave managers with a greater operating and financial flexibility. Since senior debt is almost an exclusive instrument used by our studied firms, it confirms the fact that managers of their portfolio companies do not face too rigid constraints in operating and financial decisions, though the amount of senior debt may be up to 75%.
Conversion of traditional assets into new sources of financing

Roger et al. (2002) study that conversion of traditionally fixed assets into sources of financing has been employed by some private equity firms to lower the cost of financing the acquisitions. Except for Private Equity A who has securitized its portfolio companies’ assets in few cases, other private equity firms in the study do not use securitization to raise additional fund. While securitization may reduce the cost of financing, it is difficult to be executed due to a small and narrow capital market in Sweden, as explained by Private Equity B. Private Equity C further rejects securitization as a way to partly finance buyout transactions. According to the firm, securitization reduces the value of the portfolio company’s balance sheet and subjects Private Equity C to the risk of obtaining less credit from the bank.

Although Private Equity A sometimes resorts to securitization, it in fact uses sale-lease backs more regularly. If the portfolio company has large cash tied up in fixed assets, the firm seeks to sell those assets to another company and then leases back from the buyer. Sale-lease backs are simpler to deploy and leads to a more cost-effective use of capital. Due to the complexity and difficulty associated with securitization, sale-lease backs may be used as an alternative way to deleverage the portfolio company or to raise extra cash, as has been done by Private Equity A.

6.4 Operational Engineering

Due diligence

Although operational engineering concerns fundamental changes in the operation of portfolio companies, it actually commences when private equity firms conduct corporate-governance related actions. As discussed earlier, all private equity firms in the study perform due diligence before the acquisition. During the due diligence process, the five firms try to learn about all aspects of the portfolio companies’ business. Private Equity A, for instance, goes through the entire product floor to learn about its portfolio companies’ products and customers. Private Equity B normally evaluates cash flow generation, components of cost structure and margins. Private Equity D focuses on the workflow and coordination among different apartments of the company. Information gathered from this process serves as inputs for these firms to plan operating improvement activities.

Constant follow-up

Coincident with Moon and Jensen’s findings (Jensen et al., 2006), the five firms also schedule regular meetings with managers of portfolio companies throughout the investment horizon. All studied firms stress that operational and strategic issues are always the centre of their discussions. Such a close relationship with the management team and a focus on operational matters are a clear indication of these firms’ active ownership. On the one hand, they help strengthen monitoring activities. On the other hand, they act as a dynamic mechanism, through which the firms continuously seek to implement operational changes.

Involvement of industry experts

To assist their portfolio companies, the five firms add industrialists with specific expertise on the board level or on a consultant basis. As pointed out by Berg & Gottschalg (2004), the employment of competent people with relevant knowledge and expertise is a signal of
active ownership, and leads to value creation through operational improvements that the portfolio companies have not been able to achieve on their own.

**Network of contacts**

Hoesterey proposes that portfolio companies can further rely on private equity firms’ network of contacts, including customers, suppliers and finance providers, to extend its business base (Jensen et al., 2006). However, the provision of contacts is not popular among the studied firms. Only Private Equity D mentions its use of network in helping its portfolio companies negotiate with the banks. The impression is that the five private equity firms normally use their network of industrial experts to provide portfolio companies with operational and financial advices, rather than merely forward their contacts.

Beside the common actions mentioned above, there is no single pattern to be followed by all studied firms when it comes to operational enhancement. Following Berg & Gottschalg (2004), operational changes initiated by the five firms can be classified under improvement of margins or reduction of capital requirements. Specific actions, however, vary among private equity firms and across portfolio companies. This is perhaps the reason why Wright et al. (2006) foresee operational engineering as a way for private equity firms to differentiate themselves. The diversification of operational improvement activities can be already seen in this small sample, consisting of only five private equity firms. Each firm has a different focus when working on the operational aspect of its portfolio companies.

**Cost-cutting and revenue growth**

Cost-cutting is a primary action taken by some private equity firms in the study when seeking to improve their portfolio companies’ operation.

*Divestment of non-profitable products and customers*

The most common form of cost-cutting mentioned by Private Equity A, B and E is to cut off non-profitable products and customers. Private Equity A emphasizes that cost-cutting must always couple with sales and revenue growth, rather than merely aims to lower the costs. The divestment of low-margin products and customers first enables the company to focus on what is really generating revenue, which, according to Damodaran (2001), eliminates inefficient expenses. Sale and revenue growth can be then accomplished by concentrating resources on finding new markets, extending the product range and providing more after-sales services, for those incumbent high-margin products. This practice is referred to as *organic growth* by Private Equity B, in which the company attempts to expand the business using its own resources. Berg & Gottschalg (2004) affirm that the combination of cost-cutting and revenue growth will together lead to higher margins.

*Supply chain management*

Supply chain is another area, where most studied firms realize great potential for operational improvements. According to Private Equity E, the most common decisional situation confronted by the firm is whether to make or to buy a certain item. Many times, Private Equity A, B, D and E have to outsource parts of the portfolio companies’ production process to sub-suppliers, who can do it in a more efficient and cost-effective way. The benefits perceived by these firms are a concentration on the companies’ core activities and strengths and a cutback on production cost. Outsourcing, therefore, promotes operational efficiency.
Centralizing purchases

Some private equity firms also find it highly beneficial to centralize purchases. Centralizing purchases can take place in either supply chain or distribution channel. Instead of letting each factory or sale division make its own purchases, Private Equity A and B consolidates the purchase function and thereby, gain a larger rebate from suppliers. In its attempt to centralize the distribution channel, Private Equity A reconfigures the sale process of its portfolio company according to product kind. In lieu of having a sale office selling all kinds of products in each geographic area, the firm will have each sale division specialize in one product and service customers living in different locations. Like the consolidation of input procurement, centralizing the sale process results in greater economies of scale and hence, lowers the costs as well as improves margins. Private Equity A further argues that having such product-based sale divisions in fact shifts the company’s focus from being product-oriented to customer-oriented. By specializing in a single product, each sale unit has a closer approach to customers in being able to identify their needs and to better match products’ specifications with the market demand.

However, consolidating the sale function means that the companies reduce its geographic presence to a minimum and service customers from a distance instead. Distant selling implies more traveling time and expenses, requires the distribution chain to be handled smoothly, and especially demands sale officers to be more proactive in customer relationship management. Private equity firms may take these disadvantages into account when considering the centralization of the sale process.

Reduction of capital requirements

In addition to margin growth, reduction of capital requirements is advocated by Berg & Gottschalg (2004) as an important source of value creation. Most private equity firms recognize that there are always rooms for better working capital management. Companies acquired by Private Equity A, B, C, and E typically tie up a large amount of cash in working capital, essentially inventory. Again, managers of these companies are not highly motivated in using cash more efficiently, as already discussed under the free cash flow problem. Unfortunately, actions for better inventory handling are numerous and no specific information on this matter is obtained.

Strengthening the controlling function

There is in fact another function, which poses a possibility for operational enhancement and is, yet, not touched in the literature review. Private Equity C quite often finds the need to strengthen the controlling function that is relatively lax in its acquired companies. The firm explains that managers of its portfolio companies previously did not set clear and demanding sales targets. As long as the company does reasonably well, the management is not tough on the sale forces. Nonetheless, Private Equity C aims for continuous growth and will usually add a controller. This person must be able to set key targets that are forward-looking and yet, attainable.

6.5 Strategic Redirection

All private equity firms in the study do not seek to change their portfolio companies’ strategy entirely. Private Equity D argues that a wholly novel strategy poses a greater uncertainty for the future business and hence subjects the company to a higher risk. As argued by Private Equity A, the firm would never buy a company if it did not believe in the manage-
ment’s strategy. It is usually the case that private equity firms slightly modify the current strategy. If there is an investment thesis as called by Rogers et al. (2002), the investment thesis deployed by the five firms generally consists of two legs: focus and expansion.

Focus

The first leg “focus” aims at sharpening the business strategy. It seems that portfolio companies of Private Equity A, B and C often lack a clear focus in their operating strategy. The companies may run multiple product lines, some of which are not their core competence. Additionally, operating several product lines simultaneously causes a divergence of resources. For these reasons, these private equity firms commonly divest non-core businesses and concentrate resources on core activities when they step in the companies. If the companies are relatively small with a single product line as those acquired by Private Equity E; the divestment of unrelated businesses is, however, not needed.

Expansion

To reinforce the companies’ position in its main playing field, expansion of the core business is pursued. Expansion through organic growth is discussed earlier as part of the operational engineering. Being more a matter of strategy, add-on acquisition has been increasingly favored by the studied firms (with the exception of Private Equity C and D) as an alternative for business expansion. With add-on acquisitions, private equity firms rest upon readily established businesses to extend the portfolio companies’ geographic presence.

Controversial viewpoints of the studied firms pose interesting issues surrounding this type of expansion. Based on the information disclosed by Private Equity A, B and E, four main motives behind follow-on acquisitions can be identified.

First, private equity firms embark on acquisitions of other businesses in order to cut-cost. Cost reduction can be achieved through the elimination of several managerial layers in the acquired businesses. By having the same management team monitoring a bigger company, private equity firms may create economies of scope.

Second, acquisitions enable the portfolio company to gain additional market power. Whether it is a competitor or a complementary business to be acquired, the acquisition results in a larger market share and thus, strengthens the company’s competitive position. At the same time, it reduces the risk of being driven out of the business.

Add-on acquisitions can also be induced by the desire to increase profit margins. Private Equity E explains that the allocation of profits along the value chain is not equal. For example, manufacturing industry may have a lower margin compared to the service or retailing businesses. In those cases, private equity firms may expand their portfolio companies into the service sector. In fact, this practice has been done by Private Equity A. The firm often seeks to expand to the after-sale segment. As after-sale services are attached to the product, the buyers perceive a higher value for it and hence, are willing to pay a higher price.

Finally, add-on acquisition is a way to quickly grow the companies and attracts a higher exit multiple. In short, add-on acquisition creates value to the companies through a combination of cost-cutting, economies of scope greater market power and margin improvements.

However, Private Equity C does not perceive add-on acquisition as a good way to grow the business. The firm argues that it takes management’s time and resources (both human and
capital) to do M&A; it may drive managers’ attention away from the core activities of the company; and finally, it is extremely difficult to realize the synergy effect.

It can be inferred that the decision of whether to pursue add-on acquisition to a great extent depends on each firm’s perception of the potential risk and reward. Such perception may be, in turn, determined by the history of establishment and years of experience in the buyout industry. Add-on acquisitions have been an essential value-adding element for Private Equity A and B. These two firms are bigger in size, have done add-on acquisitions for years, and possess a wide network of M&A experts, compared to the three other firms. Another factor affecting the possibility of doing add-on acquisitions is the size of the portfolio companies. To make add-on acquisitions, the companies must be sufficiently large to take over their competitors or even complementary businesses. Private Equity A, for instance, usually buys mid-sized companies while Private Equity C focuses on small businesses. Of equal importance in considering the pursuit of add-on acquisitions is the length of the ownership. Private Equity D’s holding period is between one and three years. Within such a short investment horizon, it is rather difficult to acquire additional businesses.

Having decided on an investment thesis, Zong (2005) emphasizes the importance of elaborating a business plan. Consistent with Zong’s viewpoint, the five private equity firms always craft a business plan, which is used to execute fundamental changes on a timely basis and to closely track the companies’ progress. Private Equity A and B also incorporate different scenarios (including low case, base case) into the plan and will review them annually, taking into account changes in the internal and external business environment.

As pointed out by Moon & Hoesteroy (Jensen et al., 2006), it is crucial that private equity firms have a long-term view while laying out fundamental changes in the acquired companies. All studied firms affirm that they always take a long-term focus and do not pressure managers on short-term gains. Perhaps the inherent characteristics of buyout investments play a large role in preventing short-term perspective. According to the studied firms, buyout investments are characterized by a J-curve in which profits drop dramatically in the first 12-24 months due to the implementation of numerous changes and pick up gradually towards the end of the investment period. Having understood that pattern, managers are given time to make necessary investments and private equity firms are likely to have patience for that. The market for company resale is an additional mechanism to insulate private equity firms from being myopic. After certain years, private equity firms must exit the investment. The potential buyers are not prepared to pay for the companies unless they can see that the companies have been directed towards long-term growth.

### 6.6 Timeframe

There is no single time frame to be followed by the private equity firms in this study. Actions taken in buyout investments are always case-specific. However, the common suggestion by all studied firms is that certain actions must be done early on. For example, the board of directors can be determined even before the deal is concluded. People involving in the due diligence will later be the ones sitting on the board. Radical changes (e.g., management restructuring, divestments, capital management, etc.) must be implemented early. Strategic actions such as add-on acquisitions must be planned ahead and deployed preferably within the first 12-24 months, according to Private Equity E. Early implementation of dramatic changes allows sufficient time to realize potential gains and to correct faulty actions within the limited investment period.
7 Conclusions

In this section, the authors present the conclusions drawn from the analysis. This section also includes a reflection of the authors on their study. Finally, few possible directions for further research are presented.

Competition intensifies in the Swedish buyout market. Gains through leverage are contracting. Multiple arbitrages prove difficult to be exploited. In the face of these challenges, private equity firms in the study have actively built up their portfolio companies’ value in order to preserve profits. The value-creation methods by the studied firms fall under the four themes suggested in the literature, including governance engineering, financial engineering, operational engineering and strategic redirection.

All studied firms conduct governance engineering as an attempt to remove managerial inefficiencies, which are presumably due to the lack of control by the previous owner(s). A number of governance mechanisms have been used by the five firms in designing an effective monitoring and incentivising system. Before the acquisition, a due diligence is performed with the participation of industry experts. Information gathered from the due diligence serves as guidelines for subsequent controlling activities. After the deal is concluded, the board of directors is restructured to consist of representatives from the private equity firms, industry experts and sometimes, previous owners, depending on the post-buyout ownership structure. Keeping the board small and independent of management warrants an objective and effective decision-making. To keep close control of managers’ activities and to foster the change process, scheduled board meetings (most frequently in the first year) and weekly meetings with management are arranged. During these meetings, the board focuses extensively on operational and strategic issues so as to ensure that portfolio companies receive the most advices on how to better run the business. Such a focus proves to be an important value-creation element for companies which were previously not given full attention from their parent groups.

The studied firms usually keep the current management team and seek to strengthen it on four aspects (financial, operational, controlling and supply chain management) by appointing additional personnel. Alignment of managers’ interests with the owners’ is achieved through a “carrot and whip” incentive program. No matter if managers are requested to invest in the business or are given stock options, it is crucial that managers use their own money to purchase equity stake and become effective owners of the companies. Monthly reports and evaluation of KPIs are additional mechanisms to govern managerial activities.

Financial engineering mainly concerns the use of high leverage to obtain a better capital structure and to put pressure on management. To the extent that cash has not been managed efficiently by the studied firms’ acquired companies, the hanging debt obligations incline managers to remove any idle cash and to better handle capital. In this study, Private Equity D is the only firm who does not use debt and the authors find its motive for the exclusion of debt unclear. Though the post-buyout debt ratio is relatively high, managers of portfolio companies seem not to face operating and financial inflexibility. Innovative securities, such as sale-lease backs, have been practiced by one firm to arrive at a better capital structure.

Governance engineering and financial engineering are the two conventional value-creation methods. When it comes to corporate governance and financial changes, the five firms undertake to a large extent similar actions. It is indeed operational engineering and strategic redirection that reflect the firms’ entrepreneurial capabilities and where exists the possibility for private equity firms to differentiate themselves.
Operational enhancement activities fall under either improvement of margins or reduction of capital requirements. Specific actions to achieve these objectives are numerous and vary across private equity firms. Within this study, only a limited set of actions have been identified. Higher margins are obtained through a combination of cost-cutting and revenue growth. Divestiture of non-profitable products and customers, outsourcing and centralizing purchases lead to significant reduction in production cost and greater economies of scale. Proceeds from cost savings are reinvested to extend the product range, find new markets for and add after-sale services to high-margin products, which together promote revenue growth. Better working capital management (especially inventory handling) releases tied-up cash and contributes largely to reduction of capital requirements.

There is no radical change in the strategy of the acquired companies. All studied firms continue to operate significant part of the pre-buyout business with two added twists: focus and expansion. Three out of the five firms first try to sharpen the portfolio companies’ strategic focus by divestment of non-core businesses and then extend their geographic reach by doing add-on acquisitions. The firms’ views on this type of expansion are controversial. Supporters of add-on acquisition propose that portfolio companies’ value is advanced through a combination of cost-cutting, economies of scale and scope, larger market power and margin improvements. Those against it claim that add-on acquisition takes time and resources, deviates managers’ focus on core activities, and may fail to realize synergy effects.

Although the value-creation methods are classified under the four themes, there is no clear-cut boundary between them. A certain action may relate to more than one theme. While the use of high leverage is intended to create a more efficient capital structure, it also contributes to better governance system and to more efficient working capital management. Whereas the due diligence process, the involvement of industry experts on the board level, the constant follow-up of the business by the board members as well as the periodic assessment of KPIs aim at strengthening corporate governance; these actions lay the ground on which operational changes are based.

There have been differences in actions taken by the studied firms, with regard to financial, operational and strategic matters. The type of companies acquired accounts for most differences among the firms. For example, the firms who target already profitable companies with strong cash flow typically lever the buyouts with significant debts. In contrast, the fact that the targeted companies in financial difficulty pose a high level of risk and have insufficient cash flow to meet bank obligations may provide valid reasons for Private Equity D’s exclusion of debt in deal structuring. Divestment of non-core businesses is not applicable to companies with a single product line. Add-on acquisitions cannot be performed for companies which are too small to takeover competitors. Additional factors that could explain the behavior of private equity firms are the firm size, their perception of risk and reward regarding a particular action, as well as years of experiences in the industry.

The value-creation methods are so far claimed to generate values for the portfolio companies. It is, however, not always obvious that value has actually been created. Given that non-family businesses do not suffer from the principle-agent problem or that managers already own equity stake in the pre-buyout companies, the use of incentive program needs not lead to better alignment of interests. Similarly, a small board of directors may not add values to the companies by boosting the decision-making if the acquired companies were previously run by a small board.
There is also no single timeframe for actions taken by the studied firms. What needs to be done and when is rather case-specific. The only suggestion is that owing to limited investment horizon, fundamental changes must be implemented early (preferably within 12-24 months, including add-on acquisitions) and simultaneously.

7.1 Reflections on the Study

In a buyout transaction there is always at least two parties, the acquiring firm and the acquired company. It is natural that these two parties have different views on what actions are best for the company, and what actions really create value. The authors decided to only interview the acquiring side since they are the ones who decide on what actions to be taken. However, to fully cover all aspects of the problem in a study like this, the authors realise that all parties should be heard. The authors recognize that the inclusion of only acquiring firms may lead to biased conclusions since all parties involved were not heard.

Considering the time constraint, the authors found interviewing the private equity firms to be a reasonable method. If additional time was allowed, a longitudinal study could be conducted. This kind of study could be purely phenomenological and involves participate observation at one private equity firm. Following an acquisition throughout all stages produces precise and comprehensive information on how and whether value has been created by the firm.

After the study, the authors reflected over the entrepreneurial thinking embedded within the private equity firms. The firms have a mindset that no matter if the companies acquired are in need of a turnaround or if they are profitable and industry leading, there is always room for improvement. This mindset is apparent in all the companies interviewed, as this study has shown how they strive to increase the value of their acquired companies by adding the right mix of knowledge, experience, and equity to find better and more efficient solutions of operation.

7.2 Further Research

As this study do not aim to answer whether the actions taken by the private equity firms actually leads to value creation in the acquired companies, the authors feel that this is one research direction in which this study can serve as a starting point for. The authors suggest a statistical study of pre- and post-buyout companies to assess if the value gains are attributable to the effect by the private equity firms and not only due to reason like industry upturns.

The authors noticed during this study that the firms interviewed possessed different characteristics in terms of size, preference of portfolio companies, and way of operating. Considering this, the authors believe that further studies can be directed toward finding out if different characteristics can be linked to different behavioural patterns.

As this study shows, what differentiate the firms are the actions within the two themes of operational engineering and strategic redirection. From the interviews the authors gathered that add-on acquisition within core competences is a commonly used mean to increase the value of a portfolio company. However, when conducting the literature review the authors found little research done on this field within the private equity industry. The authors find it interesting to conduct further research on the effect of add-on acquisitions on portfolio companies and in which context add-on acquisitions are applicable for buyout investments.
References


Appendix 1 - Interview questions

1. In determining whether to purchase a particular business, we believe that the company must possess potential values that get you interested in investing. What attracts you most when you consider buying a company?

2. Private equity firms in Sweden are known for their talent in accelerating the value of their portfolio companies. As a successful and experienced private equity firm, what do you do to create additional values to the portfolio companies?

   When it comes to value creation, we would like to cover the following sub-questions:
   2.1 Do you change or modify the business strategy of the company after the acquisition? What aspect must a business strategy focus on if it is to be a long-term strategy?
   2.2 How do you motivate managers of the portfolio company? What actions do you take to ensure a transparency of managerial activities (e.g., monitoring activities, appointment of an outside board member, external auditor, frequent meeting with management team, etc.)?
   2.3 Do you change the capital structure of the portfolio company? How and why do you change the capital structure?
   2.4 To what extent do you involve in the operational activities of the portfolio company? How do you use your industry knowledge and experience to support the portfolio company? How does your network of contacts help the portfolio company?

3. It is equally important that your actions are taken in a timely manner. During the investment horizon across all buyout transactions, do you follow a common timeframe that specifies when each action should be taken? If not, how do you determine when a certain action is needed?