JÖNKÖPING INTERNATIONAL BUSINESS SCHOOL
Jönköping University

Private equity bolag

Och förvaltningen av deras portföljbolag

Filosofie magisteruppsats inom finans

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Private equity firms

And the management of their portfolio companies

Master's thesis within Finance

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Master Thesis in Finance

Titel:	**Private Equity firms – And the management of their portfolio companies**
Författare:	**Ericson Carl, Forsmark Magnus**
Handledare:	**Wramsby Gunnar**
Datum:	**2006-05-30**
Ämnesord	**Private Equity, LBO, Value adding, leveraged buyouts, corporate governance, recapitalization.**

Abstract

Background: Through the late eighties leveraged buyouts were frequent in America and the giant buyout of RJR Nabisco became world renowned among investors. In the last decade the capital committed to private equity and leveraged buyouts have risen and in Sweden an amount equal to 7% of the market capitalization on the Stockholm stock exchange is placed in private equity funds. Although Private Equity firms control large amounts of capital it is relatively unclear how the private equity firms manage and add value to their portfolio companies.

Purpose: The purpose of this thesis is to analyze how private equity firms contribute to their portfolio companies in Sweden.

Methodology: This thesis has taken a qualitative approach for more in depth analysis of the private equity market. The authors have chosen to interview managers at portfolio companies acquired by private equity firms to gather data. Six portfolio companies participated in this study and the interviews were performed in a semi structured manner. As some of the information gathered could be of sensitive nature all respondents are anonymous.

Conclusion: The authors identified three areas in which the private equity firms added value; improving the margins, increasing the turnover and reducing the debt. The private equity firms used different techniques to accomplish the value improvements, both by giving the executives at the portfolio companies incentives and by forcing them to increase the efficiency in the organisation in order to be able to repay debts. The private equity firms also supports their portfolio companies by giving assistance and support in i.e. acquisitions.

Magisteruppsats inom Finansiering

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Sammanfattning

Bakgrund: I slutet av åttiotalet blev leveraged buyouts, högt belånade företagsuppköp, ett frekvent förekommande företeelse i Amerikanskt näringsliv. Det gigantiska uppköpet av RJR Nabisco är fortfarande omtalat bland världens investerare. Det senaste årtiondet har mängden kapital i private equity fonderna ökat till att idag motsvara ett kapital på runt 7% av Stockholmsbörsens värde. Samtidigt som dessa fonder kontrollerar en stor mängd kapital är det relativt okänt hur de sköter och tillför värde till sina portföljbolag.

Syfte: Syftet med denna uppsats är att analysera hur private equity bolag tillför värde till sina svenska portföljbolag.

Metod: Denna uppsats har utgått från en kvalitativ studie för en mer genomgående och djup analys av private equity marknaden. Författarna har valt att genomföra intervjuer med personer i ledande positioner hos portfölj bolagen. Totalt deltog sex stycken företag i studien. Eftersom vissa delar av informationen som insamlats kan anses vara av känslig karaktär så är alla företag anonyma.

Slutsatser: Författarna kunde urskilja tre områden där private equity bolagen skapade värde i sina portföljbolag, genom förbättrade marginaler, ökad försäljning och minskade skulder. Private equity bolagen använde olika metoder för att skapa värde inom dessa områden, ett sätt är att ge ledningen i portföljbolagen ökade incitament, ett annat är att skapa strikta återbetalningsplaner för portföljbolagen vilket tvingar dem att effektivisera verksamheten. Private equity bolagen fungerar även som bollplank och assisterar vid förvärv.

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Carl Ericson
Jönköping 2006

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Table of contents

Figures

Tables

Appendices

1 Introduction

1.1 Background

In the late eighties a wave of leveraged buyouts swept through corporate America. The largest of them all was the buyout of RJR Nabisco by the private equity firm KKR which later was described in the bestselling novel Barbarians at the gates by Burrough and Helyar. Since KKR became renowned for their 1989 buyout of Nabisco the field has evolved considerably. It has also grown in size, in 2005 the total fundraising amounted to $173,5 billion in the US, up from $42 billion in 2004 and $24 billion 2003 (Cecil, 2006). In Sweden the buyout funds manage capital which represents about 7% of the Swedish market capitalization on the Stockholm stock exchange (SVCA, 2006).

How the private equity firms manage their portfolio companies is however unclear and is a well guarded secret which the private equity firms tries to protect, just as an engineer protects his inventions. In Sweden there has been a public debate about value creation in buyouts after EQT and Investor's joint bid for the publicly traded Gambro. The private equity firm and the investment company have argued that Gambro's potential for growth and value generation is higher in a private environment outside the stock market. Why new strategies for value generation cannot be implemented in a public setting is however unclear (Peterssohn, 2006).

The Gambro affair is not the first time private equity firms' have caught public attention. Earlier this year private equity firms were depicted as locusts in the media and the industry has also been accused of only consisting of corporate raiders which lay off workers and break up companies. Henry Kravis, one of KKR's founders and the world most famous private equity investor, nevertheless claim to be socially responsible. Not only does private equity create value in the acquired companies according to Kravis, they are also socially responsible and take care of their employees. At least KKR manage to generate money for themselves, the annual IRR for their major fund have been 40% between 2002 and 2006 (Economist, 2006).

To outperform their competitors KKR has gone from having only financial expertise to assemble a network of industry experts associated to the firm. They also restructure portfolio companies immediately after the buyout with the help of their in house consulting firm (Economist, 2006). Joakim Karlsson, principal at AT Kearney, have a similar point of view and states that financial reengineering is no longer enough to derive value from buyouts, the private equity firms also need industry knowledge and operational expertise (J. Karlsson, personal communication, 2006-04-21). How well prepared are private equity firms operating in Sweden to extend beyond financial expertise and compete with Henry Kravis?

1.2 Problem discussion

The confidentiality enclosing buyouts has made the authors interested in researching the private equity industry further. The arguments why companies would develop better in private hands are inadequate and therefore this thesis authors have decided to research the value addition process in buyouts.

1. *How do private equity firms in Sweden add value to their portfolio companies.*

2. *In which areas are their contribution most prominent.*

1.3 Purpose

The purpose of this thesis is to analyze how private equity firms contribute to their portfolio companies in Sweden.

1.4 Delimitation of problem

This thesis research only concerns leveraged buyouts, except in the case of *Gamma*. The research is based on interviews with managers of portfolio companies owned by private equity firms. Therefore the empirical findings and analysis do not give evidence of any realized value creation.

1.5 The thesis' frame of reference

The frame of reference for this thesis is divided into two parts. The first section is included to give readers a better understanding of private equity and buyouts; how it is financed and the distinction between different types of buyouts. Where appropriate industry representatives such as EVCA have been used as sources, since they are responsible for creating definition guidelines for the industry.

The second part relates to the value addition process in portfolio companies and in this part the requirements on the academic level of references are higher. Primary, papers published in peer reviewed business journals have been used as sources, additionally printed literature on specific subjects has been used where appropriate. The authors have relied on quantitative studies in the references, but have tried to use an additional qualitative study to give a deeper insight to the subject. A significant difficulty was to find new writings about value creation in buyouts as most research stems from the 1980s and the early 1990s.

To find information the authors have used the school's library and additional databases provided by the library, mainly; ABI/Inform Global, JSTOR and Blackwell Synergy. In the information gathering process different search words have been used such as buyouts, LBO, value creation etc.

1.6 Fundamentals of private equity

The purpose of this section is to provide a framework for private equity and buyouts in order to support the readers understanding of the subject.

1.6.1 Private equity

Private equity is according to the British Venture Capital Association *"medium to long-term finance provided in return for an equity stake in potentially high growth unquoted companies"* (Arundale 2004, p6). The definitions of private equity and venture capital are different in the United States and Europe. In Europe venture capital is equal to private equity while in the United States it only refers to early stage financing. In this thesis the European definition of private equity and venture capital will be used in order to prevent misunderstandings (Arundale, 2004).

Private equity can be separated into three subgroups; business angels, early stage financing and buyouts. Business angels are private investors investing small amounts in very early stages of a company's life cycle. Early stage financing is investments in small and medium sized companies in expansion or growth phases, often with negative cash flows. Buyouts are investments in mature companies where investors usually take a majority stake and have an investment horizon of 4-7 years (SVCA, 2005. Arundale, 2004).

1.6.2 Buyouts

The intention with a buyout is typically to take control of a mature firm and use capital and management resources to improve the company and later divest it with a large profit (EVCA, 2004a). The average size of European buyouts in 2004 were €14 million according to the European Private Equity and Venture Capital Association's 2004 survey of the European private equity market (EVCA, 2004b).

1.6.3 Characteristics of target companies

The long term commitment and the large investment required to do a buyout creates significant risks. Consequently a buyout candidate must have a sound underlying business. One of the most important attributes is a solid cash flow since it will be needed to cover the private equity firms financing costs and it is also a buffer if the business deteriorates. A strong market position and reliable customers is also prerequisites as it is important for the stability after the buyout. Investors generally examine historic records and compare them to current performance to assess the shape of the company (O'Brien, 1995).

According to Easterwood, Seth and Singer's (1989) the perfect buyout candidate can absorb large amount of debt and do not require major investments, therefore it should be competing in a mature industry and have a very strong cash flow. This theory is supported by their research which found a majority of their sampled buyouts in mature industries; in their sample of 49 buyouts 24 were clustered in the retailing, food, steel and textile industry. The other 25 buyouts were spread over 16 industries (Easterwood et al. 1989).

1.6.4 Types of buyouts

There are different types of buyouts depending on the management structure and in this thesis the three most common forms are described. Collective for most buyouts is a very high level of debt, or leverage, which is financed by the company's cash flow (Wright, Thompson, Chiplin & Robbie, 1991).

Leveraged buyouts

Leverage buyouts are generally larger in size than management buyins and management buyouts and are the buyout type this thesis focuses on. Leverage buyouts are done by private equity firms which take control of the acquired company. The current management often receives a small amount of equity in order to stay loyal and get an incentive to improve the company's business (Krieger & Anthony, 1994). There are two approaches a private equity firm can take to manage an acquired company, either hands on or hands off (Arundale, 2004).

- Hands on

A private equity firm which take a hands on position tries to add value to the company by actively participating in business decisions and strategy work. Either the private equity firm has its own specialists or it hires external professionals (Arundale, 2004).

- Hands off

Some private equity firms take a hands off approach and let the management run the company. Even though the private equity firm does not participate in the managing of the company it scrutinize financial reports and is likely to take action if the business does not meet established targets or run into difficulties (Arundale, 2004).

Management buyouts

In a management buyout the management of a company typically arranges the deal with the present owner and then introduces it to a lender. The management receives a large share of the company and takes control while the lender is passive. Management buyouts are done in small or midsize firms since it is difficult for management to raise capital to finance buyouts of larger firms (Krieger & Anthony, 1994).

Management buyins

In a management buyin investors takes control of a company and replace the present managers with its own management team. In a management buyin the new managers will have much less inside knowledge than in a management buyout which increases the risk. Therefore the due diligence process and management team's expertise is very important in a management buyin (Krieger & Anthony, 1994).

1.6.5 Financing

Though each buyout is financed differently they generally follow a common structure, the types of capital used to do a buyout is usually a mix of senior debt, mezzanine and institutional equity. Additionally managers are often given a small amount of equity as an incentive (O'Brien, 1995).

Equity

The major equity part in a buyout comes from a private equity fund to which the private equity firm has raised money. The capital in the fund comes from investors such as banks and insurance companies and the private equity firm itself usually only commits one percent of the equity. When the fund has received enough funding it is closed for up to 10 years and when the closing date is reached the fund is liquidated and the assets are split between the investors and the private equity firm, commonly in an 80/20 division. During the time the fund is active the private equity firm leverages the capital and perform buyouts. An acquired company is called portfolio company. Figure 3-1 shows how a private equity fund is managed. The private equity firm commits management support to the portfolio companies and manage the fund while receiving a fixed fee and a large part of the profit (Meier, 2006).

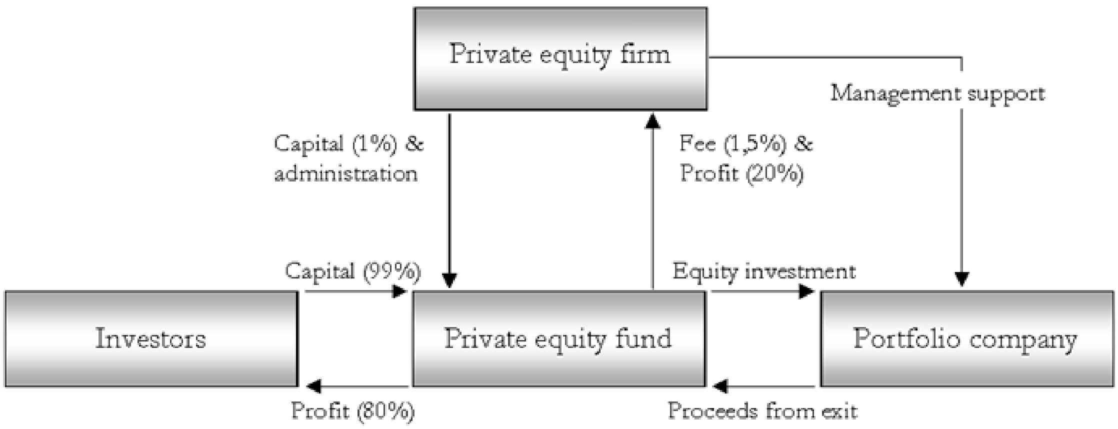

Figure 1-1 Typical private equity fund arrangement (Meier, 2006. Illustrated by the authors).

Kaplan and Shoar (2005) has studied the ability for private equity firms to raise capital and found a positive correlation to their past performance which shows that demonstrated value addition is important for the ability raise more capital in the future.

Senior debt

Senior debt is loans given by institutions such as banks. The loans are secured by the company's assets and senior debt lenders are given precedence in the case of bankruptcy (Wright et al. 1991). The protection senior debt receives makes it the cheapest type of finance. The higher the level of leverage is in a buyout, the stronger cash flow and interest rate coverage is required by the senior debt lenders (O'Brien, 1995).

Mezzanine

Mezzanine is a flexible instrument which can be used to bridge the gap between equity and senior debt. It has a higher risk than senior debt and is therefore more expensive, though it depends on how it is structured (O'Brien, 1995). Mezzanine can vary between being a high interest loan and an interest free loan where the lender receives equity. Basically mezzanine is any financing form between debt and equity (Wright et al. 1991).

1.7 Evolution of buyouts

Since buyouts erupted in the 1980s their structure and the motives behind them has changed. The 1980s were perceived as a leverage era, which was followed by the multiples expansion era in the 1990s. In the new millennium a change has been perceived where the primary focus of private equity firms' value addition comes from improving their portfolio companies' performance (Holmstrom & Kaplan, 2001. Mills, 2000). Appendix A shows how private equity investments have grown in Europe from the 1990s and onward while appendix B illustrate the private equity development in the US.

1.7.1 1980 Leverage era

According Kaplan and Stein (1993) the success of the first buyouts in the start of 1980 led to an increased interest among other investors to do buyouts. As more investors tried to join the buyout trend prices rose and the economics of the deals diminished. Of the buyouts performed in 1980 to 1984 only 2 percent defaulted on debt, while 27 percent of the buyouts done between 1985 and 1989 had defaulted by 1991. This figure is underestimated as several more companies defaulted after 1991 (Kaplan & Stein, 1993).

During this period large proportions of the buyouts were hostile and heavily contested by managers, one reason was the inefficient boards. The weak boards gave managers command of the companies which they were afraid to lose (Holmstrom & Kaplan, 2001).

Another trend in the end of 1980s was an intensified use of junk bonds, an instrument which allowed an increased use of debt and less security in the underlying assets which increased the risk. As the junk bonds allowed higher debt ratios, or leverage, prices on buyouts increased. Banks reacted by requiring more security for senior debt which further reduced its role in buyouts. The motive for the high leverage was to use it to acquire a large company, pay off debt with the company's own cash flow and later resell it which resulted in a very high IRR (Kaplan & Stein, 1993).

Kaplan and Stein (1993) conclude that the capital structure in the late 1980s was the cause of the collapse of the buyout market as it led to an upward spiral in the price of buyout candidates, and in the end private equity firms absorbed more debt than their portfolio companies could handle which led to the failure of the debt reduction method.

1.7.2 1990 Multiples era

In the 1990s debt levels were reduced. The economics of buyouts also changed according to Mills (2000). As stated in the previous section the value of buyouts in the 1980s came from debt reduction, in the 1990 the value addition instead came from multiple expansion. An example of multiple expansion; a company is acquired at a P/E multiple of 4 and divested 5 years later for a P/E at 7. This allows the private equity firm to make a considerable profit and the method was possible due to the inflow of capital into the industry during the period (Mills, 2000).

Even though the junk bond market returned in the 1990s after a decline in the first part of the decade it was not again used in buyouts, states Holmstrom and Kaplan (2001). During the 1980s buyouts were mainly hostile, this changed in the 1990s as managers and shareholders often welcomed the takeovers. Managers received incentives programs and gained significantly if the buyouts turned out to be successful and were therefore less likely to contest a takeover. Shareholders and the boards also became more active in the management of the companies and consequently there were less inefficient firms to takeover, and in the case a company was acquired it usually needed to be restructured which shareholders welcomed (Holmstrom & Kaplan, 2001).

1.7.3 2000 Growth era

During the 1990s the prices on buyout candidates were rising and when the new millennium begun it had become harder to retain a high return by using multiples expansion. This has increased the pressure on private equity firms to develop their portfolio firms according to Mills (2000). The returns from buyouts in the beginning of 2000 have to come from sales growth, margin expansion or strategic change. Therefore the organisational and strategic knowledge possessed by private equity firm managers are becoming the focal point for a successful buyout.

2 Method

This chapter describes the method used in the information gathering process and analysis in order to give the reader a better understanding of how the authors have performed the study.

The purpose of this thesis is to analyze how private equity firms manage their portfolio companies. There are two research methods which can be used to reach the purpose of a study, qualitative and quantitative method. Quantitative research can be measured and generally consists of numerical analysis done to test hypothesises. The method is objective and the research can be replicated which increases the reliability. Qualitative research involves in depth analysis of a problem, it is subject to bias and the small sample size used reduces the meaningfulness of statistical analysis. The method is functional in analysing non numerical data and testing the nature of an occurrence. As the intention with this thesis is to research the collaboration between two parts, private equity firms and portfolio companies, by doing interviews, the qualitative research method is judged to be more appropriate and will therefore be used (Grix, 2004). A quantitative analysis could have been suitable for measuring the performance of private equity firm's portfolio companies, however the authors aspire to study all aspects of how private equity firms improve their portfolio companies which cannot be achieved in a quantitative study.

The authors have chosen to interview managers at portfolio companies acquired by private equity firms in order to examine their interaction with their owners. The reasons for not interviewing the private equity firms directly is that their answers would almost certainly be too biased and not reveal more about their interaction with portfolio companies than is already official.

2.1 Data

Data is the basis from which the research results are derived. While quantitative research usually uses numerical data, qualitative research normally uses soft data or non numerical. Another difference is the use of primary or secondary data, while secondary data generally is collected in quantitative research, qualitative research generates data i.e. during the interview process. Therefore it is important for researchers using the qualitative method to be unbiased and objective while gathering primary data (Holloway, 1997). As the thesis authors have gathered secondary data through interviews it has been important to avoid subjectivity toward the findings and analysis.

2.2 Sample selection

To be able to select a sample of portfolio companies to research the authors have to understand the characteristics of the population. Sampling theory's underlying fundament "*is the principle that a subset of the elements in a population can provide us useful information which describes the entire population*" (Williams, 1997, p61). A sample survey is a selection of subsets of the elements in the population and if correctly chosen, assumptions about the population can be drawn from the sample. Prior to the sampling a list of all elements in the population has to be generated, called a sampling frame, this in order to be able to select which elements to include in the sample. The problem with a sampling frame is if any elements are left out or if elements are clustered. Clustering problems arises if a number of elements become a subgroup in another element, i.e. in the case of sampling individuals and, households are used to select elements. In this case several individuals might become clustered in one element. There are three methods to solve this dilemma. The first is to split the clusters and include all elements in them. Secondly one element can randomly be selected from the cluster. The third method is to list all elements from the clusters then select individual elements. These methods are used in probability sampling and can be used to derive statistical data (Williams, 1997).

In qualitative research non probability sampling can be used which are methods where the elements are more or less based on the selection by the authors. Judgement sampling, a type of non probability sampling, is a procedure where the authors pick elements based on how representative they are in the population (Williams, 1997).

This thesis authors have used a mix of probability sampling and non probability sampling. To find the relevant clusters a sample survey of the Swedish private equity market was performed and three main clusters could be identified; international, major Swedish and minor Swedish private equity firms. To find information the authors used EVCA's directory of private equity firms, SVCA's homepage and read business articles concerning private equity. Subsequently a sampling frame was created where the portfolio companies in the clusters were listed. Then the authors made a selection of companies from the sampling frame. The major Swedish private equity firms were considered the most important as the authors regard them as the most active in Sweden and they set the standard for other private equity firms operating in Sweden.

The sample size in qualitative research is not restricted by rules as it is in quantitative research where statistical inference is important. Instead the sample size depends on the purpose of the study and what the researchers wants to find out. In cases where the researchers' wants to study a problem in depth and it is information intense a small sample is superior to probability sampling (Patton, 1990). Therefore the authors choose a sample of seven companies. Four from the major Swedish private equity firms, one from a minor Swedish private equity firm and two from international private equity firms. Of these the authors succeeded in interviewing all companies, except one major Swedish private equity firm. To assist the readers the companies are named after the Greek alphabet, the major Swedish private equity firms are called Alpha, Beta and Epsilon. The minor Swedish private equity firm is called Delta, and the international private equity firms are called Gamma and Zeta.

2.3 Interviews

There are two main types of interviews which can be used, structured or unstructured interviews. As the name suggest structured interviews follows a prearranged outline with fixed questions. It is useful when a large number of interviews are done or the researchers have several people carry out the interviews, the high degree of standardisation however makes the technique inflexible. Unstructured interviews have a discussion like format in which the interview person i.e. describes his or hers life and the researchers afterwards analyse the conversation. This method is practical in the beginning of a research phase or when the researchers want to have an open mind about the subject, the information will however be diverse and not comparable (Grix, 2004).

This thesis uses a combination of both techniques, called semi-structured. Ten questions chosen beforehand are asked. The questions are open to allow follow up questions if the authors find it appropriate and if it can give valuable information to the thesis. The advantage of doing semi-structured interviews is the possibility of both comparing the data and also receive more in depth information (Grix, 2004). The questions asked by the authors have been derived from the findings in the theoretical framework, the authors have also researched the companies in advance to be able to ask relevant follow up questions. The authors have conducted this research by studying available material on the companies' Web-Pages, reading press releases and searching for financial and company information on Affärsdata. An example of what could be relevant is the board composition, change in top management, strategy changes or acquisitions.

To be able to obtain as much relevant information as possible the types of questions asked are as important as the questions themselves. There are four main types of questions which should be included in interviews according to Berg (1995) and which have been utilized by this thesis authors; essential, extra, throw away and probing questions. The essential questions are the main questions needed to fulfil the purpose of the study, in this case there are nine questions. Extra questions are similar to essential questions and are included to verify the respondents' answers. Throw away questions are used in the opening of the interview in order to create an understanding between the interviewers and the respondent. In this thesis the authors have tried to create an amiable atmosphere between them and the respondent, in addition the interviews have started with a question of how the buyout was perceived in the company. The authors' reason for this is to start a discussion about the buyout and also to distinguish the respondent's attitude towards the buyout. The last type of questions is probing questions which are used to reveal more information and get a full picture (Berg, 1995). In interviews it is imperative to have a clear communication between the interviewers and the respondents to avoid problems originating from confusion about the intention of the interview, language misinterpretations or difficulty level of the questions (Berg, 1995). The interview questions with corresponding explanations are found in appendix C.

As the interviews are performed in both the interviewers and respondents' native language there is limited risks of misinterpretations, and all respondents are experienced executives which had no problem to understand the questions. To avoid confusion about the intention of the interview, the respondents received the essential questions in advance along with the thesis purpose and problem statement. As the subject matter discussed concerned sensitive information it was important for the authors to build a relation of trust between us and the respondents, therefore only face to face interviews were done. To get in touch with the respondents the authors contacted them by phone. All respondents were interviewed anonymously and in all but one case a recorder was used. The information sent out the respondents before the interview are found in appendix D.

The average interview time was 45 minutes and the interviews were performed between the second and 19th of May 2006.

2.4 Analysis of data

Information gathering is of no purpose by itself. In research it is just as important to analyze, decipher and present the result. In qualitative research there are no regulations of how data should be analyzed, instead there are guiding principles and the analysis is based on the judgement and expertise of the researchers. There are two methods which can be used to depict an interview, case or cross case. If the analysis starts with a case study each interview is portrayed separately first, this is suitable if the main focus of the research is to find differences between the subjects. Cross case can be used to portray the interviews when standardized questions are employed, it is applied by clustering the answers from the respondent under the corresponding questions (Patton, 1990).

As the purpose of the interviews made in connection with this thesis is to discover how one firm influences another, the authors believe it is important to first depict the complete interviews to understand the implications in each company. After considering the alternatives, the authors have decided to start with a separate study of each interview and then continue with a cross analysis. The reason for doing a cross analysis is that the interview questions overlap each other and therefore it is necessary to categorize the answers under each theoretical section. Before the analysis of the findings in chapter 5 in the context of the theoretical framework, there is a brief discussion of the empirical findings.

There are several strategies toward analysing the empirical findings in a qualitative or case study, the primary approach is to use the theoretical proposition as the basis and it is also the method this thesis authors have chosen. The theoretical framework has shaped the research questions and the results from the interviews are analyzed in retrospect to the theoretical findings (Yin, 1994).

2.5 Method evaluation

When writing a thesis the trustworthiness is very important, as it involves the credibility of the results. If the research is not performed in a trustworthy manner the analysis and conclusions are of no value. There are two measures used to ensure the quality of research; reliability and validity. Unlike quantitative research which is objective, qualitative research is subjective. The implication of this is the increased importance of the ethical manner in which the authors have performed the research (Merriam, 1998).

The concept of reliability involves to which degree the study can be replicated with an equivalent result (Wiedersheim-Paul & Eriksson, 1989). Qualitative research is however always subjective as it is based on the opinions of people, and therefore *"reliability is problematic in the social sciences simply because human behavior is never static"* (Merriam, 1998, p205). As peoples' attitudes change over time the authors cannot guarantee the reliability of the research, however we have tried to conduct the research in an unbiased manner and depict the methodology used meticulously to facilitate replications of the study.

Validity is defined by Wiedersheim-Paul and Eriksson (1989) as the method's ability to give an answer to the research question. There are two concepts of validity; internal and external. Internal validity relates to which degree the research correspond to the reality (Merriam, 1998), as the respondents in this thesis are executives in companies acquired by private equity firms we consider their views to demonstrate the truth in each specific company. However this truth may not be applicable to the entire population and as stated in the previous paragraph the world is dynamic and ever changing. External validity deal with how generalizable a study is and if it is applicable in other situations. In quantitative studies with small non random samples such as this thesis, the result should not be considered as the truth but instead be regarded as a perspective of the reality. The authors' analysis and conclusions can therefore not be generalized on the entire population but may perhaps instead be considered as a working hypothesis, open for further studies (Merriam, 1998).

3 Theoretical framework

This chapter presents the theoretical framework for value addition in buyouts.

3.1 Value addition in a leverage buyout

The aim for private equity firms is to create value for themselves but also their investors according to Meier (2006). For a private equity firm trying to raise capital to their funds a solid reputation of giving a high yield is important since investors are more likely to put their money in the hands of a private equity firm with a strong past performance. The only long term approach to generate high returns for a private equity firm is to add value to its portfolio companies.

Kaplan and Schoar (2005) have found S&P 500 to outperform buyouts between 1980 and 1997. However, there is a large variety in returns where experienced private equity firms attain higher returns than newcomers. Notably private equity firms which raise money during expansion phases in the economy underperforms, possibly because eager investors provide capital to new firms as the experienced private equity firms have already closed their funds. Meier (2006) did not however find any concluding evidence of a correlation between private equity firm experience and value addition, which he suggests is because new private equity firms are more diligent and less arrogant.

A basic definition of how a portfolio company is adding value: *"if payments from a company to the stakeholder exceed the payments from the stakeholder to the company"* (Meier, 2006, p17). To achieve this, gains from dividends and exits has to surpass costs, such as fees from lawyers, accountants and costs for banking arrangements (Meier, 2006).

Berg and Gottschalg (2005) use a basic formula for value addition in a portfolio company:

*Equity value = Valuation multiple * revenues * margin – net debt*

A portfolio company's value can be appreciated through change in any of these components. During the 1980s value was mainly added through reduction of debt and in the 1990s multiples expansion were used to increase the value of portfolio companies (Kaplan & Stein, 1993. Mills, 2000). As competition and prices have increased for potential buyout candidates the importance of those two components has been reduced. Instead sales growth and higher margins are the main components of value addition at the start of the new millennium according to Mills (2000).

The valuation multiple depends on both the performance of the firm but also to a high degree the market valuation of comparable companies, which is beyond the control of the private equity firm. Changes in the capital structure i.e. reduced debt can also increase the value of a portfolio company (Berg and Gottschalg, 2005). Multiples expansion is not derived from any change in the companies as such but is instead realized at the exit and is therefore not the focus of this thesis.

Revenue growth and higher margins comes from *operation improvement* and *financial changes*. These two factors affect the bottom line directly while a third factor, *corporate governance*, can implicitly enhance their effect. The improvements can either come from the portfolio company management or by hands on involvement by the private equity firm depending on their *interaction* (Berg and Gottschalg, 2005). These four factors are the basis for the value addition framework in this thesis; *corporate governance, financial changes, operational improvements* and *value adding interaction.*

The case study of the buyout of O.M Scott in 1986 written by Baker and Wruck (1989) will be added to each section where it is possible in order to give an additional empirical perspective on buyouts. The case gives a good insight to the value creation process in buyouts during the 1980s and is widely cited in research papers concerning private equity. O.M Scott is a lawn care producer in the United States which was acquired by a private equity firm with support from the management. The buyout amounted to $211 million from which 91% was financed by debt. The management received a 17,5% share of the equity, the private equity firm 62% and debt holders the rest. Two years after the buyout EBIT was up 56% and sales up 25%, despite increased marketing and R&D expenditure. The authors of this thesis do not consider the case of O.M. Scott to have any statistical significance but instead use it to exemplify how a company changes after a buyout.

3.1.1 Corporate governance

Corporate governance relates to the division of ownership and management, and is aimed to be a protection for shareholders'. (Tirole, 2001).

In a company there are generally conflicting interests among managers and shareholders according to Jensen (1986). Management commonly desire to run larger corporations and may therefore invest in new projects and product areas which are not likely to generate higher returns. Shareholders may instead be interested in owning cost effective organisations which produce large dividends. Dividend payouts however limit the capital under management control and limit their influence. The analysis of this discrepancy is called the *agency cost theory*. The conflict arises when free cash flow exist, it is the net cash flow which is left after required expenses. One way a private equity firm can reduce the agency cost of free cash flow for a portfolio company is to leverage it. The leverage can be a substitute for dividends as management will be forced to pay off the debt and cannot use the cash flow for unproductive investments. Another gain from additional debt can be the motivation factor, as the risk of bankruptcy can make employees work harder, also debt repayments face less opposition than dividends in the organisation (Jensen, 1986).

Another way of aligning the interests of management with shareholders is to increase the managements' equity share as it should lead to a shift from growth expansion to shareholder return maximization. Phan and Hill (1995) found a significant increase in the management equity share post buyout compared to pre buyout in a survey of 214 companies which underwent buyouts in 1986 to 1989 (Phan & Hill, 1995).

Singh's (1990) research confirms this hypothesis in a study performed on 65 buyouts between 1980 and 1987 which found an increased shareholding among management in firms which have gone through a buyout compared to firms which remained public. Divisional managers experienced the largest change as they both received considerably more responsibility and incentives. Singh (1990) however warns of potential conflicts between managers and shareholders, especially matters regarding if and when to go public.

In a study performed by Singh (1990) he found a sharp increase in shareholders' board representation after buyouts which indicate that private equity firms take a more active role, also management and senior debt lenders take a larger share of the board at the expense of independent board members. This implies a reduction in the gap between the company and its owners.

After the buyout of O.M. Scott the private equity firm immediately changed the compensation package for management, also the management had received a 17,5% equity share which made them substantial shareholders in O.M. Scott. The incentives program was extended to include additional managers and salaries were raised, the intention from the private equity firm was that management were more valuable to them than they were to the previous owner since the organisation was decentralised and more authority was given to middle managers. The high debt levels also forced management to increase the efficiency of the organisation to strengthen the cash flow in order to meet the debt repayments. The management succeeded with this despite increased marketing and R&D expenditure. However, the private equity firm put much higher demands on the management performance and required them to work longer hours. Managers who did not meet the standards were encouraged to work harder or forced to quit (Baker & Wruck, 1989).

After the buyout of O.M. Scott the board composition changed, of the five members of the board the private equity firm appointed three of its partners. An external expert was also appointed while management only had one representative in the board (Baker & Wruck, 1989).

3.1.2 Financial changes

This section relates to the right side of the balance sheet.

As the private equity firms' are professionals in the financial area they can help their portfolio companies to renegotiate terms for senior debt or assist in contacts with banking and financial institutions. The private equity firms may also do a recapitalization on their portfolio companies, in other words change the capital structure to obtain the most favourable combination of debt and equity (Berg & Gottschalg, 2005).

In a way recapitalizations are similar to leveraged buyouts, but without the transfer of control. Basically a recapitalization involves a large dividend payout to shareholders financed by new debt injected into the company (Gupta & Rosenthal, 1991).

According to Walker (1998) recapitalizations are done by equity holders trying to discipline management as the increased costs of debts will force them to run the organisation more efficiently. Recapitalizations also provide shareholders with sizeable short term pay outs. Walker's (1998) research however shows that return on equity is lost in a four year period as the operating profit decrease after a recapitalization, which he sees as evidence that recapitalizations do not add value or enhance the efficiency (Walker, 1998).

3.1.3 Operational improvement

This section relates to the left side of the balance sheet.

Operational improvement occurs when a company increases the efficiency in the use of its resources. The improvements can come from cost cutting, better productivity, reduced capital requirements and even dismissal of underperforming managers, which have a positive effect on the sales margin and cash flow (Berg & Gottschalg, 2005).

For management to be able to decrease costs in order to create a more effective organisation it is important to see beyond financial reports and instead understand the underlying business of the firm, both internally and externally. A cost system has to be tailored to each organisation and be adjusted depending on if it is in the service or manufacturing industry (Doyle, 1996)

To control costs in a manufacturing firm the initial step is to analyze the separate activities conducted by the firm, it involves fragmentation of the firms' activities and examining each of them separately; such as sales, order taking, pricing, planning, manufacturing and service. Being able to map out costs created in each activity is beneficiary for the firm in many ways, as it makes it possible to do a cost/profit analysis and evaluate if the activity add value to the firm. It also helps recognising how activities affect the overhead which gives a more accurate description of the real production cost of each product. Especially expenses for transports and storage are costs often not associated to a separate product (Doyle, 1996)

Muscarella and Vetsuypens (1990) studied 72 companies which underwent a buyout and later were made public again. It found a considerable increase in profitability which mainly came from the ability to reduce costs. Decreased capital expenditure were the main source of cost savings while no program for reduction among employees had been set up.

According to Singh (1990) a large amount of receivables in relation to sales is a sign of low control of operations. He notes that firms which are going through a buyout have much higher revenue growth and better cost control than other firms in the industry, the cause of this is not entirely clear but it could be related to increased incentives and equity stakes for management. The most important operational improvements were made in inventory management and receivables and took place in extraordinarily short amount of time.

In O.M. Scott the private equity firm externally advised the management of the company, however management had the operational responsibility for reducing capital requirements. A special group was formed with a goal to decrease the working capital with 42% in two years, the group managed to surpass the target and reached a 62% reduction. Improvements were made in cash control, production, inventory management, receivables, payables and the size of the workforce (Baker & Wruck, 1989). After the buyout a cash management system were implemented to track and predict the cash flow, which had grown more important.

Strategic changes

Value addition from operational improvements can be derived from other sources than higher operational efficiency and cost cutting. Refocusing the strategy and change of the company's market position can be a significant source of value creation (Berg & Gottschalg, 2005). According to Easterwood et. al. (1989) the debt repayment in a buyout forces the private equity firm to divest its portfolio company's unprofitable or time consuming businesses.

When change is considered in the organisation the problem which needs to be resolved must first be identified. In a simple case a company can be facing increased competition, a solution to this problem could be to change the pricing strategy or step up marketing efforts. Depending on the degree of change it may have large effects on the organisation and managers have to be cautious when implementing changes. Small problems should not be solved by major strategic overhauls as there are usually a trade off between doing an evolutionary or revolutionary change since quick changes may create dissent among employees (Callahan, Fleenor & Knudson, 1986).

In a study by Seth and Easterwood (1993) they found that in a total sample of 32 buyouts, 14 had increased the focus in their core businesses. Also 14 firms had undertaken acquisition led expansions, which were clearly focused on strengthening the chosen strategy by, for example economy of scale. Buyouts are according to Seth and Easterwood (1993) an instrument which allows strategic alignment in the firm and divestment of unrelated businesses. This allows better firm performance and higher asset efficiency. The high cost of debt however makes strategic mistakes fatal.

Baker and Wruck's (1989) case study of the leveraged buyout of O.M. Scott found changes in the strategy due to the buyout. Before the buyout the previous owners had been hesitant to undertake measures to preserve O.M. Scott's position in the market despite increased competition. Post buyout the management received support from the private equity firm to perform a large acquisition (the acquired firm matched O.M. Scott in size) to reinforce the firms product line which allowed the company to use two labels to target different segments. O.M. Scott also broadened their business, from only selling do it yourself products, to extend and sell to the turf maintenance market.

3.1.4 Value adding interaction

Meier (2006) studied different approaches for a private equity firm to work together with its portfolio companies, which one to use depends on the level of formality and frequency they prefer to interact. Counselling through board members is quite formal, while using consultants and managers can create a more informal relation between the private equity firm and its portfolio companies. No immediate evidence of which approach is more effective could be found. According to Meier (2006) there are three components needed for a private equity firm to add value to its portfolio company. These three are *information*, *implementation* and use of *external resources*.

Information

To be able to design successful strategies information is always a necessity. For a private equity firm which operates under considerable risks because of high leverage, accurate information is critical. To obtain information regular contact with the portfolio company is a requisite. Even though distance communication through emails and phone calls are enough in some occasions, only meetings can give all necessary information. Meier (2006) discourage private equity firms to try to remote control their portfolio companies.

Equally important is the quality of the information received. The figures and data received from the CFO in the portfolio company have to be correct and error free. It should also be customized to the needs of the private equity firm as it is time consuming to process large amounts of information. The significance of precise information can be challenging for a CFO and it is common to have either him or her replaced (Meier, 2006).

Implementation

The information received should be used by the private equity firms to improve the performance of the portfolio companies. According to Meier (2006) it is important to use a proactive approach to implementation, as "*hands-on involvement actually does add value to a portfolio company*" (Meier, 2006, p119). Delaying an implementation plan can become costly and ideally a strategy for improvement should be designed before the takeover, so it can be executed immediately.

An effective hand on approach requires the private equity firm to work closely with its portfolio company states Meier (2006). A private equity firm should understand the operational issues and work closely together with the company's management to help improve activities. Issues such as sales growth and improvement of margins are some of the most important for the private equity firm trying to add value to its investment.

External resources

The last factor in successfully adding value to a portfolio company is to appoint specialists to support activities. External resources are expensive but important according to Meier (2006), since they can help add value. There are two fundamental types of external resources which could be used; industry experts and executive recruiters. Industry experts should be used in the implementation phase and support management in the decision making process. It is best to use a few skilled specialists and avoid involving an excessive amount of people. Executive recruiters are an important part when additional managers are required or the original set of managers are underperforming and needs to be replaced (Meier, 2006).

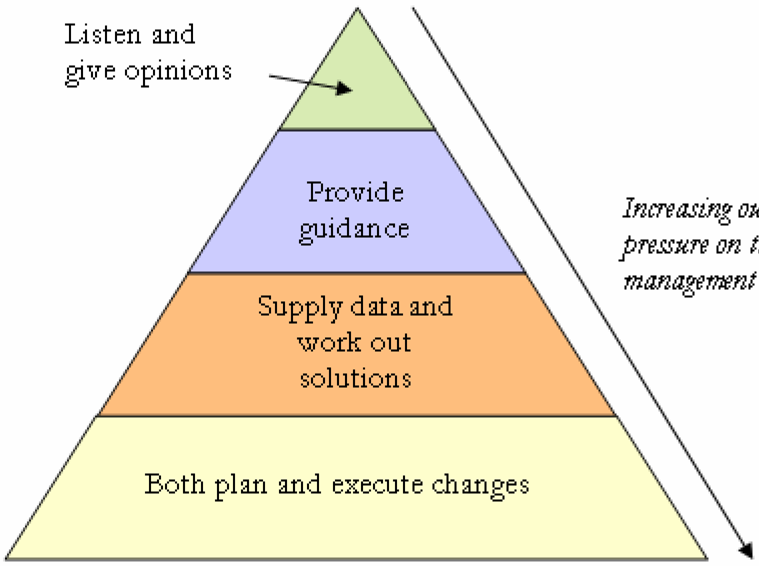

Figure 3-1 External pressure on management (Callahan et al., 1986. Illustrated by the authors).

A person outside an organisation, i.e. a consultant, has to choose to which degree he wants to become involved in the process of change. The level of participation will affect the pressure put on the incumbent management. Figure 4-2 illustrates how external directors can affect the direction of a firm by different levels of participation. Even though direct execution might give quick results it can put unnecessary pressure on the firm's managers and decrease moral. One tactic which can be used is to allow a manager to execute major changes and later replace him with a gentler manager in order to calm employees and moderate the opposition (Callahan, Fleenor & Knudson, 1986).

3.1.5 Summary of value addition

This is a summary of the theoretical findings structured in its respective category. The purpose is to assist readers in the comprehension of the theoretical framework and facilitate understanding of the analysis.

Corporate Governance	Financial changes	Operational changes	Value adding interaction
➢ Implementing incentives programs. ➢ Give management an equity share. ➢ Force the company to repay large amounts of debt. ➢ Increase shareholder representation in the board.	➢ Leverage the portfolio companies. ➢ Do a recapitalization to optimize the capital structure. ➢ Assist in financial transactions and renegotiation of debt.	➢ Reduction of working capital by decreasing i.e. inventories and receivables. ➢ Develop cost control systems. ➢ Improve the cash flow. ➢ Strategic focus and divestment of unsuccessful divisions.	➢ Receive precise information regularly. ➢ Have personal meetings with the management. ➢ Have hands on involvement while implementing changes. ➢ Use external resources such as industry experts. ➢ Use professional recruiters when needed.

Table 3-1 Summary of value addition

4 Empirical Findings

This section begins with the empirical findings derived from the interviews with the portfolio companies, and is followed by a cross analysis. The purpose of this disposition is to make the empirical findings more comprehensible and facilitate reading of the analysis in chapter 5.

4.1 Companies

There are six companies studied post buyout in this thesis. These are sorted into three groups; major Swedish, minor Swedish and international private equity firms. The company descriptions are general without details since the Swedish private equity market is relatively small and the authors wish to protect the respondents' secrecy. The companies are named after the Greek alphabet instead of numbers to make reading easier.

- **Major Swedish private equity firms – Alpha, Beta & Epsilon**
  Each company in this segment have a turnover between SEK 1 and 6 billion.

- **Minor Swedish private equity firms – Delta**
  There is only one company represented in this category and it has a turnover of SEK 200 to 400 million.

- **International private equity firm – Gamma & Zeta**
  In this group there are two subsidiaries, one with a turnover of SEK 400 to 800 million, and another one with a turnover of SEK 1 to 2 billion.

4.1.1 Alpha

Alpha has turnover of SEK 1 billion to 2 billion. The company is engaged in the manufacturing industry and targets both the consumer and business to business market. The company was acquired by a major Swedish private equity firm which took a majority stake. The executive interviewed is one of the top managers with good insight in the buyout process.

- **How did the buyout affect the company?**
  The buyout did not lead to major changes and it created positive expectations as the owners became more visible. The previous owners managed the company by routine and were less active. The new owners provided the company with an identity and a clearer role of who was in charge.

1) **How does the private equity firm contribute?**
   The private equity firm has not been involved in daily operations but influenced the company by being active board members. After the buyout the private equity firm has two members in the board, there are three external members plus the CEO, the CFO also participates in the meetings to give input on the financial data. Preceding the buyout board meetings were routine, this changed and instead became an important institution for decision making. The private equity firm's board members also offer advice and feedback on strategic issues.

During the 100 day plan[1] consultants were involved in the project. It had a significant impact on the improvements made during the first stage of the buyout. Their role was not to control, instead their role was to encourage employees to express their opinions which created a positive spirit in the workforce. At *Alpha* the consultants were considered professional and their participation successful, since their listen and support approach did not create conflicts inside the firm.

2) **Has the private equity firm improved the operating performance?**
Increased pressure to perform led to higher efficiency, the private equity firm formulated goals and expected constant improvement. A stress list, which is a list of goals, was set up and later followed up. The private equity firm uses projects to enhance the efficiency in certain areas which lagged behind. These projects were closely monitored and continuously reviewed by the private equity firm.

   At the time of the buyout a 100 day plan was initiated. This led to an improved understanding of the company, both for the private equity firm but also to a significant extent the management and employees. It also created enthusiasm in the workforce as they could observe the results from their work.

3) **Has the private equity firm changed the strategy or focus of the company?**
The original strategy of the business has not been changed although the focus on certain aspects has increased. The focus on the portfolio company's core strengths have increased. Before the buyout the private equity firm had planned strategic changes, which were never realized as the industry fundamentals were different from what the private equity firm had projected.

4) **Has the private equity firm assisted in acquisitions?**
The original strategy from the private equity was to grow by acquisitions and a few major companies were evaluated. The private equity firm assisted in valuations and due diligence of companies, however the lack of suitable candidates put the focus on organic growth instead. Expansion through acquisitions is still on the agenda, although the management is concerned that the brand could become diluted if the company acquired new product lines which do not fit with the original company.

5) **Has the private equity firm contributed with new contacts or customers?**
No

6) **Have the private equity firm implemented incentives programs or given executives an equity stake?**
The private equity firm has changed the incentive system for the CEO and CFO to increase their rewards if the company meets its financial goals, with a specific focus on the cash flow. Additionally around 10 to 15 key employees have received an equity stake in the company. From the start it amounted to about 5% of the portfolio company, this part however increases if the company improves its performance. It resembles a compensation package with options. There is a negative aspect of the incentive program as well since management almost becomes hostage to the private equity firm, locked up in golden handcuffs.

[1] It is a thorough due diligence of the entire company directly after the buyout in which strategies and operations are put under total scrutiny.

7) **Does the private equity firm assist in or influence recruitments?**
For a private equity firm a skilled management team is extremely important as it cannot add value by itself and therefore is completely dependent on the management. However in this case no changes were needed. One person was employed as chief of investor relations on the initiative of the private equity firm, although it was not involved in the recruitment process.

8) **Has the private equity firm changed the financial operations?**
The requirements on financial reports did not increase, however the focus on specific key ratios and cash flow were significant. Business deals in the industry have long lead times which create a lagging effect in cash flow and profits. This also makes it difficult to make forecasts, which were a concern for the private equity firm since cash flow predictions are very important in buyouts. In the end they together managed to create a tool to make consistent and accurate projections.

   Prior to the buyout the company did not have significant amount of loans in their balance sheet, the new loan situation did however have limited impact on the company since the cash flow without difficulty could cover interest payments and amortizations. Post buyout the firm underwent a recapitalization, in which the private equity firm assisted with contacts in the financial markets when negotiating new debt terms.

9) **Within which area has the most prominent changes been made?**
The most significant changes have been made in the financial operations. Especially the focus on cash flow has been important and positive for the company. Also the new debt structure has led to changes in the attitude to the financial proceedings.

4.1.2 Beta

Beta has a turnover of SEK 2 billion to 4 billion. The company is engaged in the manufacturing and services industry and their main customers are private consumers and families. The company was acquired by a major Swedish private equity firm which took a majority stake. The executive interviewed is a top manager who has regular contact with the private equity firm.

- **How did the buyout affect the company?**
Directly after the buyout many employees at *Beta* were anxious since being part of a larger corporation gave a sense of security. After a while however the workforce changed its attitude towards the private equity firm, and now employees appreciates the new owners. The buyout put *Beta* in the spotlight in a new way and the company could control investments and develop independently.

1) **How does the private equity firm contribute?**
The private equity firm took a Vice Chairman position in the board and one deputy position. A professional board member was chosen as Chairman, and additionally a few other industry experts have been elected to the board. The private equity firm has governed the company through the use of board decision, but as its knowledge of the industry is limited they have taken in additional external members with different specialist knowledge. Their major role has been to give advice and feedback on ideas.

   Furthermore consultants are used, although not to a great extent.

2) **Has the private equity firm improved the operating performance?**
The main efficiency gains however, comes as a consequence of increased demands from the private equity firm which has pushed the management to perform. Being lifted out of a larger corporation made individual managers more visible and intensified their efforts.

3) **Has the private equity firm changed the strategy or focus of the company?**
The private equity firm supported a strategic shift to be more consumer oriented. The company became more involved in the sales and after sales service to provide customers with a system, not just a product. Also increased efforts in marketing and branding were implemented. The private equity firm encourages a strategy to reach the high end of the market with premium prices and hopefully higher margins.

   The private equity firm put a larger focus on continuous strategy evaluation than had previously been done when *Beta* was part of a larger corporation. One example of a strategic shift was the bold move into retail selling, which put the company in competition with its retailers. Another example is a large acquisition which expanded their portfolio with a second brand.

4) **Has the private equity firm assisted in acquisitions?**
After the buyout a few small acquisitions have been made without the private equity firm's involvement. However in one significant acquisition the private equity firm assisted with capital and financial knowledge. Even though *Beta* probably could have financed the transaction themselves the private equity firm's ability to obtain documentation and basic data for decision making was valuable. The private equity firm also brought in external advisers.

5) **Has the private equity firm contributed with new contacts or customers?**
The private equity firm mainly assisted in contacts with financial and legal advisors, no commercial contacts or customers.

6) **Have the private equity firm implemented incentives programs or given executives an equity stake?**
A result based incentives program were implemented for executives and key employees. Additionally a bonus is given to all employees if the company meets certain targets.

   The executives also got the opportunity to take a relatively large equity stake in the company which decreased the agency costs as it aligned the management's and the private equity firm's objectives. Overall the loyalty to the company increased from an already high level.

7) **Does the private equity firm assist in or influence recruitments?**
The private equity firm did not have a significant impact on recruitments. However they supported the employment of a new CFO who could set up new financial information systems as its importance had become imminent.

8) **Has the private equity firm changed the financial operations?**
One of the first things the private equity firm did was to set up a system for corporate finance and risk management as those functions had been part of the larger corporation previously. A major threat to the business was the currency risk and a

system was set up to handle this. Making accurate prognosis also became more important.

As *Beta* was rather leveraged there was a focus on cash flow generation. The private equity firm put indirect pressure on the executives to increase cash flow and minimize working capital by forcing the company to repay debts. They made clear to the management there was no point to ask for more capital if they ran out of cash.

Additionally the private equity firm did a recapitalization which optimized the capital structure and again increased the leverage.

9) **Within which area has the most prominent changes been made?**
   The private equity firm mainly added value to *Beta* by supporting the management, and especially by promoting new projects.

4.1.3 Gamma

Gamma have a turnover of around SEK 400-800 million. The company is a subsidiary of a larger corporation which was acquired by an American private equity firm. The main customers are larger companies and the public sector. The executive interviewed had a key position in the Swedish subsidiary and had reporting responsibilities to the American private equity firm.

- **How did the buyout affect the company?**
  The private equity firm entered the company and took direct control, which created frustration and confusion in the management group. Managers had to file individual reports to the private equity firm which had a negative effect on teamwork and company spirit. Instead of thinking as one unit the different sections such as production and administration cut down on their collaboration. The private equity firm did not communicate with the management or explain the motives for change which caused confusion. The private equity firm main concern was to extract as much cash as possible in the shortest period of time.

1) **How does the private equity firm contribute?**
   As *Gamma* was a division of a larger corporation the private equity firm did not take any positions in the board. Instead it required the top executives to send reports directly to the private equity firm. Each executive had to file its own report instead of using board meetings to form consensus. This created a situation where the managers focused on keeping their own backs free instead of cooperating. This technique of dividing and conquering made managers' work harder, but it also led to a dismal atmosphere in the company.

   During the 100 day process external consultants took control of the business. The consultants gave direct orders without dialog, and their decision could not be objected. These consultants became the de facto management and no decisions could be made without their consent.

2) **Has the private equity firm improved the operating performance?**
   During the 100 day program directly after the buyout a major focus was put upon the production process. The short term cash flow was the new focal point for the company and instead of short delivery times as the objective, low inventories became the new target. Reduction of working capital and increased cash flow became very important short term goals. Previous to the buyout having short delivery times

had been one of the mottos, this changed as low inventories instead became the focus as the private equity firm wanted to reduce working capital. Management was concerned as the longer delivery times hurt customer relations.

The production was changed with new projects such as lean production and rapid improvement. From *Gamma's* point of view the projects were short sighted and lacked the overall picture. The company experienced more of a one way communication with the management of the private equity firm. The decisions of the private equity firm should not be questioned. By doing something different you had to assume the risk of the entire project.

3) **Has the private equity firm changed the strategy or focus of the company?**
The private equity firm promotes selling within the cooperation and creating synergies instead of acting as independent subsidiaries.

4) **Has the private equity firm assisted in acquisitions?**
No

5) **Has the private equity firm contributed with new contacts or customers?**
As *Gamma* was part of a larger multinational corporation the different subsidiaries traded and sold their products to each other. This however caused concern among the management in *Gamma* of a possible deterioration of its brand.

6) **Have the private equity firm implemented incentives programs or given executives an equity stake?**
No, not in the Swedish division.

7) **Does the private equity firm assist in or influence recruitments?**
All new top or middle managers had to be interviewed by the directors in the main cooperation, but *Gamma* could still influence the recruitment process.

8) **Has the private equity firm changed the financial operations?**
A significant shift in the entire company towards financial thinking took place, where controllers received a more prominent role. Reducing working capital was the focus as the private equity firm wanted to turn it into cash.

The reason for the cost reductions was to elevate the value of the company. If the value of *Gamma* is P/E multiple of 5 and EBITDA is $100m, a 20% increase in EBITDA signify a $100m increase in the value of the company. Additionally the value of the company was increased by repayment of debt, resembling the method used in the 1980s. Reports and repayments were sent to the private equity firm without any feedback or response.

9) **Within which area has the most prominent changes been made?**
The production.

4.1.4 Delta

Delta has a turnover of around SEK 200-400 million. The company sell high end products to consumers, but have no in house production. It is owned by a minor Swedish private equity firm which has a minority stake in relation to the founders. The private equity firm entered the company in a combination of buyout and issue of new stock after a bidding process. The private equity firm's reputation was also a determinant for the founders in choosing which bid to accept.

- **How did the buyout affect the company?**
  As the founders kept the control it did not create any effects for the workforce and the change was natural for the management as the buyout was planned.

1) **How does the private equity firm contribute?**
   The private equity firm has two representatives in the board and increased the importance of board meetings, it also requests monthly reports about the operating performance and financial situation. The presence of two external board members has formalized the decision making process and increased the demands on new proposals.

2) **Has the private equity firm improved the operating performance?**
   Since the sales growth and profitability has surpassed the targets the private equity firm has not taken an active role. As long as *Delta* continues to perform the private equity firm will stay passive.

3) **Has the private equity firm changed the strategy or focus of the company?**
   Not the fundamental strategy, however the private equity firm has insisted on making long term plans for future growth. Additionally it has supported a foreign expansion, as private equity firms always are interested in profit and sales growth to increase the value of their portfolio companies.

4) **Has the private equity firm assisted in acquisitions?**
   Indirectly the private equity assists by sharing the risk in acquisitions, corresponding to the proportion of their ownership. They also reinforced *Delta's* financial position in acquisitions by using the capital which was invested in connection with the buyout. Additionally the private equity firm supported with input and opinions.

5) **Has the private equity firm contributed with new contacts or customers?**
   No new customers, although they have assisted with contacts in the financial sector.

6) **Have the private equity firm implemented incentives programs or given executives an equity stake?**
   No, as the founders still have an equity stake and have management positions it has not been necessary.

7) **Does the private equity firm assist in or influence recruitments?**
   No.

8) **Has the private equity firm changed the financial operations?**
   There has been no recapitalization in *Delta* after the buyout and the private equity firm has not changed the capital structure. Instead it has monitored the financial situation and given advice

9) **Within which area has the most prominent changes been made?**
   In the activity level of the board meetings and in the financial reporting.

4.1.5 Epsilon

Epsilon has a turnover of SEK 4 to 6 billion. It is engaged in the manufacturing industry with sales mainly toward the business to business market. The company was a subsidiary of a larger corporation and was divested and acquired by a major Swedish private equity firm. The executive interviewed is one of the top managers.

- **How did the buyout affect the company?**
  It involved some changes for the management but none for the workforce.

1) **How does the private equity firm contribute?**
   The private equity firm replaced the entire board and elected three own representatives to the board. It also selected two industry experts to the board. It did not use any consultants or perform a 100 day program. The board receives both monthly and quarterly reports about the financial situation.

2) **Has the private equity firm improved the operating performance?**
   Not directly, instead the pressures from debt repayments have forced the company to improve even though there have not been any significant changes. The board have also set up targets and projects to improve specific areas.

3) **Has the private equity firm changed the strategy or focus of the company?**
   No, the private equity firm wants to keep the focus *Epsilon* had before it was acquired. However the plan is to grow both organically and by acquisitions.

4) **Has the private equity firm assisted in acquisitions?**
   No acquisitions have been made so far, although the private equity firm has assisted in valuations. If any acquisition targets appear the private equity firm could aid in financing.

5) **Has the private equity firm contributed with new contacts or customers?**
   No

6) **Have the private equity firm implemented incentives programs or given executives an equity stake?**
   Around 50 managers got the opportunity to take an equity stake in *Epsilon*, in order to align management and the private equity firm's objectives. The negative aspect of this is that the managers do not have much choice but to accept to participate. This is comparable to golden handcuffs, especially for managers who have to borrow money to finance the equity stake. The incentives program employed before the buyout was kept generally unchanged.

7) **Does the private equity firm assist in or influence recruitments?**
   No.

8) **Has the private equity firm changed the financial operations?**
   A completely new financial structure, the existing debts were replaced with new ones and the leverage was increased. The reporting system was improved with a focus on specific key figures such as cash flow, profit and debt ratio.

9) **Within which area has the most prominent changes been made?**
   The financing and the capital structure.

4.1.6 Zeta

The *Zeta Group* has a turnover of SEK 4 to 7 billion, and the Swedish subsidiary *Zeta*, which was studied, has a turnover of SEK 1 to 3 billion. It is engaged in the manufacturing industry with sales mainly toward the business to business market and all products are custom made. The company was a subsidiary of a larger corporation and was divested to an international private equity firm, which merged it with another firm in a related industry. The company, *Zeta Group*, has its headquarters in Europe while the main division, *Zeta*, is located in Sweden. The executive interviewed by the authors is one of the top managers in the Swedish subsidiary.

- **How did the buyout affect the company?**
  Initially it created a positive sentiment in the company, as it was relief to become independent from the conglomerate it had previously been attached to. The buyout was also perceived as positive among the employees. Post buyout cultural clashes appeared as the private equity firm focused on details, while *Zeta* was used to work toward goals.

1) **How does the private equity firm contribute?**
   The private equity firm has not taken any positions in the board of the Swedish subsidiary. However the CEO of the *Zeta Group*, who was appointed by the private equity firm, is the Chairman of the board of *Zeta*. The private equity firm has had limited personal contact with the company and mainly controlled *Zeta* through financial reports and by conference calls. A new system was set up where the head of each section had to file their own reports to the *Zeta Group*, i.e. the HR chief and CFO in Sweden became subordinates to the president of respective section in Europe instead of reporting to the Swedish CEO. The new arrangement started to break down the team spirit among the Swedish managers, and to prevent this development focus has been put on uniting the management team.

   During the first year after the buyout the company worked intensively with consultants, which were appointed by the private equity firm. This was something new to *Zeta* and created discomfort.

2) **Has the private equity firm improved the operating performance?**
   Not directly, instead the private equity firm has mainly governed through goals and targets. However immediately after the buyout the private equity firm set in motion a restructuring plan with a focus on reducing the number of geographic locations with production. Several factories were closed down.

   New production procedures were implemented, although the only novel about them was the name of the systems. A focus on reducing the working capital by lowering inventories meant that the customer service decreased. Overall the private equity firm has been more active than the previous owner and implemented changes quicker.

   During the first period when consultants were used a program similar to a 100 day plan was initiated where the entire organisation was scrutinized and the focus was put on cost control and improving EBITDA.

3) **Has the private equity firm changed the strategy or focus of the company?**
   Zeta's business idea has not changed, except a larger focus has been put on the core competence after the buyout. A strategic shift toward increasing the production in

Europe was set in motion, and one of the factories closed down in Sweden was moved abroad. The strategy has however been unsuccessful as both organic and growth by acquisitions failed.

4) **Has the private equity firm assisted in acquisitions?**
No related acquisitions for *Zeta* were made, although the strategy for *Zeta Group* had been to expand in Europe through acquisitions. The private equity firm tried to find potential buyout candidates without success. The plan is to build a large and attractive corporation for an exit.

5) **Has the private equity firm contributed with new contacts or customers?**
No.

6) **Have the private equity firm implemented incentives programs or given executives an equity stake?**
Only five managers in the *Zeta Group* received an equity stake, this was a disappointment as the expectations were that the program would include more managers. The incentives program was wider and more beneficial than it had been before the buyout.

7) **Does the private equity firm assist in or influence recruitments?**
The private equity firm had tried to change the recruitment process in Sweden, without success. In the *Zeta Group* the entire management was replaced after less than a year and a new team was setup by the private equity firm.

8) **Has the private equity firm changed the financial operations?**
A new financial structure was created after the buyout with a very high leverage. The finance consisted of a mix of senior debt and mezzanine debt with different levels of interest rates, where the costly mezzanine was repaid first.

The significant debt costs put an emphasis on increasing cash flow and reducing the working capital to be able to meet the repayment obligations. The private equity firm requires exhaustive financial reports, in which almost every possible key figure is monitored. An example of how thorough the private equity firm's analyses are, is that they questioned why the electricity bills swell in January. One key figure which received an increased attention was receivables and the collection of them, as a consequence outstanding receivables were reduced considerably.

The private equity firm has been very restrictive when it comes to new investments in the business and a larger effort is needed to get projects approved.

9) **Within which area has the most prominent changes been made?**
In the financial structure and procedures. Working without cash positions sometimes put strain on operations but increased the awareness of cash flow.

4.2 Cross study

This is a compilation of the answers from the interviews with the representative from each company. The findings from the companies is sorted into each category from the theoretical framework, the purpose is to make it easier to understand the analysis.

Corporate Governance	Financial changes	Operational changes	Interaction
Alpha ➢ Incentives programs for CEO and CFO, in addition to an equity stake for 10 to 15 managers. ➢ The private equity firm took two places in the board and made meetings more important.	**Alpha** ➢ Change of debt structure. ➢ Increased leverage. ➢ A recapitalization post buyout was done. ➢ The private equity firm aided in financial discussions with banks.	**Alpha** ➢ Focus on cash flow and specific key ratios. ➢ Continuous projects to improve performance in certain areas. ➢ A 100 day program initiated directly after the buyout to develop the entire organisation.	**Alpha** ➢ Higher demands on reports and financial projections. ➢ Communication through board meetings. ➢ Used consultants in the first phase after the buyout. ➢ Experienced directors as external board members.
Beta ➢ An incentives program for executives and key employees. A bonus for all workers if the company reach specific targets. ➢ Executives got the opportunity to take an equity stake. ➢ Debt repayments. ➢ The private equity firm seized two places in the board.	**Beta** ➢ Change of debt structure. ➢ They performed a recapitalization post buyout. ➢ Increased leverage. ➢ Assisted in contacts with financial institutions.	**Beta** ➢ Setting up systems for risk management. ➢ Focus on cash flow and minimization of the working capital. ➢ Strategic change toward consumer orientation. Target a higher segment and increase value added.	**Beta** ➢ It became essential to make accurate projections. ➢ Contact through formal board members. ➢ Industry professionals elected to the board. ➢ Recruitment of a new CFO. ➢ A limited use of consultants.
Gamma ➢ Repayment of debt.	**Gamma** ➢ Change of debt structure. ➢ Increased leverage.	**Gamma** ➢ Extreme focus on cash flow. ➢ Reduction of working capital by lowering inventories. ➢ Implementation of lean production and rapid improvement.	**Gamma** ➢ Involvement in the recruitment process. ➢ Extreme hands on involvement initially. ➢ Increased demands on reporting. ➢ Use of consultants.

Table 4-1 Compilation of empirical findings, 1-3.

Corporate Governance	Financial changes	Operational changes	Interaction
Delta ➢ Two positions in the board which increased the board activity.	**Delta** ➢ Assisted in bank negotiations and monitored the financial situation.	**Delta** ➢ Increased focus on long term planning and growth.	**Delta** ➢ Monthly reporting of financial data. ➢ A hands off involvement . ➢ Formal board meetings the primary channel of communication.
Epsilon ➢ Around 50 managers took an equity stake. ➢ The private equity firm took three places in the board. ➢ Significant debt repayments.	**Epsilon** ➢ Change of debt structure. ➢ Increased leverage.	**Epsilon** ➢ Implementation of new reporting systems with focus on cash flow and specific key figures. ➢ Some improvements through specific projects.	**Epsilon** ➢ Higher requirements on financial reports. ➢ Monthly and quarterly reports. ➢ Formal contact through board meetings. ➢ Election of industry experts to the board.
Zeta ➢ Extended incentives program. ➢ Substantial debt repayments.	**Zeta** ➢ Change of debt structure. ➢ Increased leverage.	**Zeta** ➢ Focus on working capital reduction i.e. receivables. ➢ Attention to cash flow. ➢ Project based production improvements. ➢ A small number of production facilities were closed.	**Zeta** ➢ Financial reports became more important. ➢ Contact through conference calls. ➢ Some improvement through specific projects. ➢ Initially hands on approach. ➢ Use of consultants in the beginning.

Table 4-2 Compilation of empirical findings, 4-6.

5 Analysis

In this chapter the theoretical and empirical findings are analyzed in relation to the four elements of value addition. To assist the reader the empirical findings from each element is discussed before they are analyzed in context to the theoretical framework. The four sections are corporate governance, financial improvement, operational improvement and value adding interaction.

The empirical discussion will be brief and mainly concern the similarities and differences between the portfolio companies after the buyout, derived from the interviews. In order to understand the implications in each company chapter four should to be read prior to this chapter. To be able to identify when a portfolio company is mentioned their names are written in italic. Each of the sections begins with a short abstract from the theoretical framework to remind the reader of the general theories.

5.1 Corporate governance

Corporate governance relates to the division of ownership and management, and is aimed to be a protection for shareholders' (Tirole, 2001).

Empirical discussion

All private equity firms have taken two or three positions in the board of their portfolio companies, except in *Gamma* and *Zeta* as they are subsidiaries. The private equity firms have also been active and increased the importance of board meetings in the companies where they have had positions in the board.

Management in the subsidiaries *Gamma* and *Zeta* did not get the opportunity to participate in an equity program, and at *Delta* management to a large extent is made up of the founders who already had a significant equity stake before the acquisition. In *Alpha* and *Beta* 10 to 15 managers got the opportunity to take an equity share, while around 50 managers took an equity stake in *Epsilon*. In the *Zeta Group* however, which was indirectly studied, only about five managers received equity despite its significant turnover.

Incentives programs were used in all portfolio companies except *Gamma* and *Delta.* As with the equity program the scale of the incentives programs varied in size. *Beta* sticks out with a bonus program for all employees.

All companies were heavily leveraged and forced to make large debt repayments, except *Delta* as the buyout of the company was not leveraged.

Analysis

According to Singh's (1990) research, private equity firms increase their participation and take a more active role in their portfolio companies in order reduce the gap between the company and its owners. His research corresponds to this thesis finding which have shown increased board activity and involvement from the private equity firms in all portfolio companies except two.

In all portfolio companies which underwent a leveraged buyout and were not subsidiaries the management received an equity stake. Incentives programs were even more widely used. This correlates strongly with Phan and Hill's (1995) research which showed that private equity firms use equity and incentives to align the executives' objectives with their own. The research by Singh (1990) shows similar results as Phan and Hill (1995), he warns however that it can cause conflicts between executives and shareholders when planning for an exit. Particularly *Alpha* and *Beta* correlate with the case of O.M. Scott where management also received extended incentives programs and significant equity stakes (Baker & Wruck, 1989). However no previous research studied has found a company with as extensive incentives program as *Beta's*, concerning the amount of people involved. Some of the executives interviewed were however hesitant if the equity stakes were only positive. They state that it can be tough to reject an offer to take an equity stake as it could be considered disloyal. Some managers might need to borrow money to be able to finance the equity, which lock the managers' capital to the will of the private equity firm. In the end the equity becomes something which could be considered as golden handcuffs[2] making it very difficult to leave the firm according to the managers. No evidence of this could however be found in the previous studies.

The final aspect of aligning the management objectives with the shareholders is the more forceful method described by Jensen (1986) in which the private equity firm leverage their portfolio companies and force them to repay debt, in order to prevent management from investing in unprofitable projects. This type of debt repayments was used in all studied companies except *Delta*, and several executives interviewed concluded that it was the main technique used to control management. In O.M. Scott debt was similarly used to put pressure on management (Baker & Wruck, 1989).

5.2 Financial changes

As the private equity firms' are professionals in the financial area they can help their portfolio companies in contacts with financial institutions. The private equity firms may also recapitalise their portfolio companies (Berg & Gottschalg, 2005).

Empirical discussion

As mentioned the private equity firms in general were significantly leveraged, the private equity firms also rebuilt the capital structure. As *Alpha* and *Beta* was successful and managed to repay their debts a recapitalisation were performed which again increased the leverage.

Three of the portfolio companies, *Alpha*, *Beta* and *Delta*, received support in contacts with financial institutions and renegotiations of debt.

Analysis

Gupta and Rosenthal (1991) describe a recapitalisation as a large dividend payout to shareholders, Walker (1998) however states that the gains from a recapitalisation is lost in a four year period as a result of declining profits. The implication of this for the long term outcome of the recapitalisations at *Alpha* and *Beta* is unclear.

According to Berg and Gottschalg (2005) private equity firms can support in contacts with banks. The authors have not found this to have a significant impact, although three of the portfolio companies have received some assistance.

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[2] Golden handcuffs are a reward allocated to the employees to encourage them stay at the firm. An example is incentives given to managers, which they lose if they leave the company.

5.3 Operational changes

Operational improvement occurs when a company increases the efficiency in the use of its resources, it can be derived from other sources than higher operational efficiency and cost cutting; refocusing the strategy can be a significant source of value (Berg & Gottschalg, 2005).

Empirical discussion

In half of the companies, *Beta*, *Gamma* and *Zeta*, it became important to lower the working capital after the buyout, mainly by reducing inventories and receivables.

In *Alpha*, *Gamma* and *Zeta* a major overhaul of the operations were done after the buyout with a large focus on cost control. The similarity between the companies is the use of 100 day plans or comparable programs. The executive at *Gamma* explained that one of the intentions behind the cost reductions was to increase the margins in order to raise the value of the company.

Due to the new debt situation in all portfolio companies except *Delta*, a significant focus was put on cash flow as it was needed to repay debts. The improvements however mainly came as result of the pressure rather than input from the private equity firms.

Strategic changes

Beta has seen the largest strategic redirection of the portfolio companies with its shift towards consumer orientation and retailing. In the other companies there have not been any realized strategic changes, instead they have increased their focus on the core business. In *Delta* this even resulted in the closure of a small number of factories. *Alpha*, *Beta*, *Delta* and *Zeta* have planned to expand by acquisitions, though these plans have yet to be realized.

Analysis

In order to reduce cost in a company it is according to Doyle (1996) important to first do an assessment of the entire firm to identify cost drivers and how they are associated to each separate product. Muscarella and Vetsuypens's (1990) research show a considerable profit increase in companies after buyouts, mainly derived from cost reductions. In *Alpha*, *Gamma* and *Zeta* the private equity firms took direct control of the companies and used different plans with the purpose of controlling costs, corresponding to the suggestions by Doyle (1996), though this thesis have not studied how effective these plans have been. Singh (1990) also found companies which were subject to buyouts to have higher revenues and improved cost control, which he conceived to be because of the additional incentives for management. In *Beta* where the currency risk was significant, a system was set up to control this, relating to Doyle (1996) who puts emphasis on the understanding of costs in the underlying business, beyond financial reports.

The primary factor behind the operational improvements in the companies studied by Singh (1990) was the reduction of receivables and inventory, similar results was shown in the study by Muscarella and Vetsuypens (1990) which conclude the main reason for lower costs post buyout is the reduced capital expenditure. In three of the studied companies inventory and receivables were reduced by the private equity firms linking to Singh's (1990) findings. In *Zeta* the private equity firm had imposed restrictions for new investments, connection with Muscarella and Vetsuypens (1990) theories of enforced reductions in capital expenditure after buyouts. The findings from the studied companies also correspond to the case of O.M. Scott where the focus was put on reducing working capital and controlling costs (Baker & Wruck, 1989).

Berg and Gottschalg (2005) claims that reduced working capital and lower costs increase the cash flow. Correspondingly, in an absolute majority of the examined companies large debt repayments had obliged them to improve the cash flow, which was largely done by decreasing the working capital and cost cutting. To *Beta* the private equity firm stated that if they ran out of cash it was their own problem to solve it.

Strategic changes

According to Seth and Easterwood (1993) companies which undergo a buyout increase their focus on their core businesses, this is consistent with the findings from this thesis companies in which all had strengthened the strategic focus. Seth and Easterwood (1993) also found a tendency toward related acquisitions in order to expand, and conversely divestments of unrelated businesses. Correspondingly to Seth and Easterwood's (1993) study *Beta* has undertaken several strategic acquisitions and *Alpha*, *Beta* and *Zeta* have planned to grow by acquisitions. *Zeta* has also closed redundant production facilities. *Delta* instead planned to grow organically.

In *Beta* a large acquisition was performed in order to extend the product portfolio with a second brand and the strategic focus of the firm shifted toward consumer orientation. This is similar to Baker and Wruck's (1989) findings from O.M. Scott, where an acquisition was performed to create two labels which could sell to different segments. The acquisition was supported by the private equity firm which were more open to investments than the previous owners of O.M Scott. Even though the private equity firms according to the respondents in this study were careful with the capital, they similarly to O.M Scott's owners did not hesitate to do large investments or acquisitions if the right opportunities emerged.

5.4 Value adding interaction

There are different approaches for a private equity firm to work together with its portfolio companies, which one to use depends on the level of formality and frequency they prefer to interact (Meier, 2006).

Empirical discussion

In all studied companies the demands on the reporting increased after the buyout, except in *Beta* due to the already high standards of their reports. The reports were usually sent on a monthly basis. All companies apart from the subsidiaries had regular and more active board meetings with the private equity firms, instead of being a formality the board meetings became an important institution for decision making.

With the exception of *Delta* and *Epsilon* all private equity firms used consultants, especially at an early stage. *Gamma* and *Zeta* stick out since the consultants were more deeply involved. In all companies which were acquired by major Swedish private equity firms industry professionals were elected to the board.

In *Alpha* and *Epsilon* the private equity firms governed with goals and targets which are contrary to *Gamma* and *Zeta* in which the private equity firms meddled in details.

Only in the companies acquired by international private equity firms the new owners tried to influence the recruitment process, except in *Beta* and *Alpha* where on one occasion each the private equity firms' appointed a new executive.

Analysis

Meier (2006) state that it is critical to receive regular information from portfolio companies, equally important is the choice of key figures to include and the quality of the data. All the companies in this study are required to send regular reports to the private equity firms. The private equity firms put notable focus on specific key figures such as cash flow, debt and profits, converging with Meier's (2006) theories.

The majority of the companies had regular board meetings in which the private equity firms participated. Meier (2006) consider personal communication between the portfolio companies and the private equity firms to be very important, but that board meetings are a formal way of interacting with the portfolio companies. However the executives at *Alpha* and *Beta* consider the meetings less formal after the buyout and instead it has become an important body for discussion and decision making, where the private equity firms have taken a very active role. At *Delta* and *Epsilon* the meetings have been less important but the private equity firms have nonetheless been present. According to Meier (2006) it is important for private equity firms to be active in operational issues and to work closely together with management, concisely to take a hands on approach as the private equity firms have done in *Alpha* and *Beta*.

In three of the companies consultants were utilized directly after the buyouts which correspond to Meier (2006) who suggest that programs for operational improvements should be executed immediately.

Meier (2006) conclude that two types of external resources should be used in the portfolio companies; industry experts and external executive recruiters. The external experts should according to Meier (2006) be used in the implementation phase to support management. However only the major Swedish private equity firms use industry experts, and primary in the board as advisors. Meier's (2006) rationale for using external executive recruiters is to quickly be able to find new executives or replace underperforming managers, especially the CFO is commonly replaced due to the significant pressure created by the financial reports. In the portfolio companies acquired by international private equity firms the new owners had tried to influence the recruitment procedure and in *Zeta Group* the entire top management was replaced. At *Beta* a new CFO and at *Alpha* a CIO was appointed, if the private equity firms used external recruiters is not known although it would be surprising if they managed the process themselves.

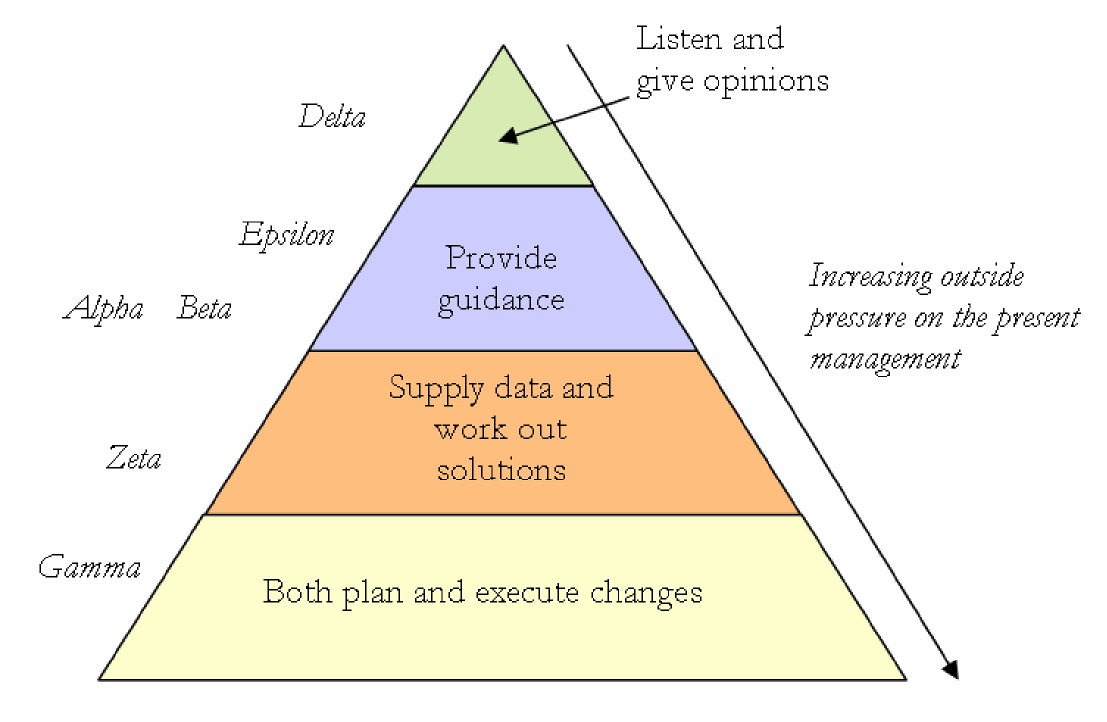

Figure 5-1 External pressure on management (Callahan et al., 1986. Illustrated by the authors).

According to Callahan et al. (1986) the level of participation by the private equity firm or the consultants creates an external pressure on the portfolio companies' management, if the external directors carry out too much of the day to day operations it can put pressure on managers and lower moral. There is a clear division among the different private equity segments on how much they are involved in the portfolio companies operations. At *Delta* the minor Swedish private equity firm merely participate in the board meetings. The international private equity firms on the other hand are much more involved in the daily business of their portfolio companies. Post buyout the Swedish major private equity firms have an involvement somewhere between the two other segments, in their role as active board members. In figure 5-1 the authors have tried to estimate the position of the private equity firms' involvement in their portfolio companies by using Callahan et al.'s (1986) model.

6 Conclusion and discussion

This chapter include the conclusion, authors' comments and further studies.

"The best executive is the one who has sense enough to pick good men to do what he wants done, and self-restraint to keep from meddling with them while they do it."
~ Theodore Roosevelt

6.1 Conclusion

The purpose of this thesis is to analyze how private equity firms contribute to their portfolio companies in Sweden.

The first research question will be answered in the context of the four parts of value addition. The second question is discussed in the perspective of the formula for value addition in buyouts.

1. *How do private equity firms in Sweden add value to their portfolio companies.*

Corporate governance

The private equity firms generally protect their portfolio companies from management waste by a combination of a carrot and a stick[3] technique. Executives in the non-subsidiaries received equity and incentives in order to align their interest with the private equity firms and decrease agency cost. A confirmation of the equity stakes ability to align management with the shareholders objective is the fact that only the two executives without equity were critical towards the private equity firms. However the private equity firms also force their portfolio companies to repay large debts and allow no slack in the organisations. The responsibility to improve is put on management and several of the respondents consider this to be the private equity firms' main instrument for control. Notably *Delta*, owned by a minor Swedish private equity firm, stick out as no debt pressure at all has been put on the company.

Financial changes

The financial changes in the portfolio companies have had more implicit effects, apart from the large debts. As the private equity firms' speciality is finance they arrange the debt structure in the buyouts, however there is considerable confidentiality enclosing this area. Some of the private equity firms have helped their portfolio companies to renegotiate debts and assisted in contacts with banks. The most noteworthy aspect was the recapitalisation in *Alpha* and *Beta* which delivers a significant short term payout to the private equity firms.

Operational changes

As a consequence of the debt repayments the private equity firms needed to improve the portfolio company's cash flow. To increase the cash flow the companies had to cut costs and reduce the working capital. Improvements in operations are thus derived from intensified efforts from management rather than assistance from the private equity firms. In

[3] Combination of a reward and penalty, "morot och piska" in Swedish.

Gamma and *Zeta* where the private equity firms tried to implement new production systems it was met by scepticism, the managers disliked the hands on approach.

Strategic changes
All studied companies focused on their core business after the buyout and tried to grow within this area. The private equity firms either wanted to do acquisitions or grow organically, preferably abroad. The motive for this is to "dress the lady" as one respondent portrayed it, boost the sales as much as possible in order to increase the value of the company before the exit. A company which is market leader and is present in several markets can be sold for a higher price. This is probably the reason why the private equity firms on one hand want to reduce capital expenditure, but at the same time quickly can finance larger acquisitions.

Value adding interaction

All private equity firms had increased the requirements on the financial reports, the impression the authors got from talking to the respondents were that these reports create significant pressure on executives. This is the only similarity between the three groups of private equity firms when it comes to interaction with the portfolio companies.

The major Swedish private equity firms are active in the board meetings and come up with new ideas and give feedback on the executives' proposals. They also elect industry experts to the boards, who give important support to the management on i.e. strategic issues. This seems to be a competitive advantage for Swedish private equity firms, as they are familiar with the Swedish industry and know which experienced executives who would be appropriate to elect to the board of a company in exchange for the opportunity to take an equity stake. The international private equity firms on the other hand exercise authority over their portfolio companies and both use consultants to a large extent and interfere in details, clashing with the Swedish company culture.

Only the minor Swedish private equity firm took a hands off approach. The reason for this is unclear, but it could be because *Beta* is fairly successful and the private equity firm is concentrating their efforts on their portfolio companies which lag behind.

2. *In which areas are their contribution most prominent.*

The area in which the private equity firms contribute the most can be discussed in the perspective of the formula for value addition in buyouts proposed by Berg and Gottschalg (2005): *Equity value = Valuation multiple*[4] ** revenues * margin – net debt*

When scrutinizing the answers from the respondents and analyze them in the context of the theoretical framework it is evident that the private equity firms are, regardless of the level of involvement, trying to improve its portfolio companies in all components. Except the minor Swedish private equity firm which did not impose any debt pressure. The *sales revenues* are enhanced by acquisitions or organic growth. The pressure to increase the cash flow by reducing costs leads to *higher margins*. Finally as a consequence of the large debt repayments the *net debt* decreases.

[4] This component is as stated previously not discussed in this thesis as it is realized at the exit and is to a large degree affected by the economic cycle.

All things considered the pressure from debt repayments have to be deemed as the main contributor of value to the portfolio companies as it both indirectly enhance margins and increase the value of the firm as the debt decreases.

6.2 Authors' comments

In both the companies which were acquired by international private equity firms there were significant cultural clashes. The private equity firms have caused tension in the organisations by implementing new procedures which force divisional executives to send separate reports, infringing on the cooperation traditionally in use in Swedish companies. Another issue the international private equity firms tendency towards meddling in the details instead of governing with goals and targets. To smooth out the cultural hurdles the authors recommend the private equity firms to appoint people with knowledge of the Swedish culture, or at least perform a cultural due diligence. An additional issue with the international private equity firms is their inability to see the whole picture and instead focus on details. One executive for example received the question why their electricity bill always rose in January, the executive remarked that *"you do not need a large student debt to figure out the reason why"*.

As mentioned in the conclusion the Swedish private equity firms employ industry experts and appoint them to the boards of their portfolio companies. Several renowned businessmen have been in the boards of the portfolio companies analyzed. The possibility of being able to obtain considerable equity stakes without drawing attention from the media is a plausible reason why private equity appeals experienced executives.

The managers at portfolio companies divested from larger corporations did not give credit to the private equity firm for the improved performance. Instead the main factor behind the enhancement was the positive and intrapreneurial spirit unfolding throughout the organisations.

One interesting phenomenon in the private equity industry is the recapitalisations which result in large dividend payouts to the private equity firm, but also increases the level of debt and therefore lower the value of the portfolio company. Possibly the private equity firm perform a recapitalisation as an alternative to selling the portfolio company. Another conceivable motive is that the private equity firms want a certain guaranteed repayment before an exit, as there is always a risk that the exit process breaks apart due to uncertainties such as an unattractive stock market.

As a concluding remark several managers mentioned the quick financing the private equity firms can provide. Contrasting to publicly traded companies, private equity owned companies can execute acquisitions quicker and obtain capital faster. This is one of the reasons why private equity firms can be so heavily leveraged, compared to public firms which needs several months to attain refinancing through issue of shares. It conveys a significant competitive advantage for private equity firms, but is it sustainable when the interest rates rise?

6.3 Critique

An obvious criticism of this thesis methodology is the use of the qualitative methodology which makes statistical inferences about the private equity market irrelevant. The small sample could also be criticized, even though a larger test would have probably generated too much data.

A more relevant critique can be given to the choice of samples. Instead of choosing companies from all clusters, the focus could have been put on only the major Swedish private equity companies. It would possibly have given more consistent findings. It is not however an entire mistake to sample the two other clusters. The different approaches to interacting with the portfolio companies between Swedish and international private equity firms were interesting to observe and gave some important input.

The use of anonymous interviews was the only solution to gather the data needed to answer the research purpose. There is however some negative aspects of the anonymity. During the interview process the authors have come across information which could have helped to answer the research purpose, but would have jeopardized the anonymity of the respondents. This creates an information gap between the readers and the authors.

As no previous study of this type has been performed on the Swedish private equity market the choice of questions was difficult, and if the study could be performed again the selection of questions would be different. The section concerning the financial changes on the right side of the balance sheet would be excluded as it had limited impact on the portfolio companies. The majority of information concerning this is enclosed in confidentiality. Overall the information gathered balances on the border of what is possible to obtain due to confidentiality.

The four sections of the theoretical framework for value addition can sometimes seem to overlap. However the same occurrence, i.e. additional board positions for shareholders can have implications in different sections. In corporate governance it would be an indication that the owners try to reduce the gap between them and management. Within value adding interaction it would on the other hand be a sign of shareholders trying to take an active role in the management of the company.

6.4 Further studies

Within this thesis area of research there are several opportunities for further studies. Relatively few papers within the area of private equity have been written, especially with a Swedish perspective. One interesting study would be to conduct a more focused study on one single company to fully understand all the actions and implications a buyout represents. A similar study of OM Scott on the Swedish market could be performed.

Another field that could be studied further is the differences in management between Swedish and International private equity firms. The differences were larger than the authors had anticipated.

7 References

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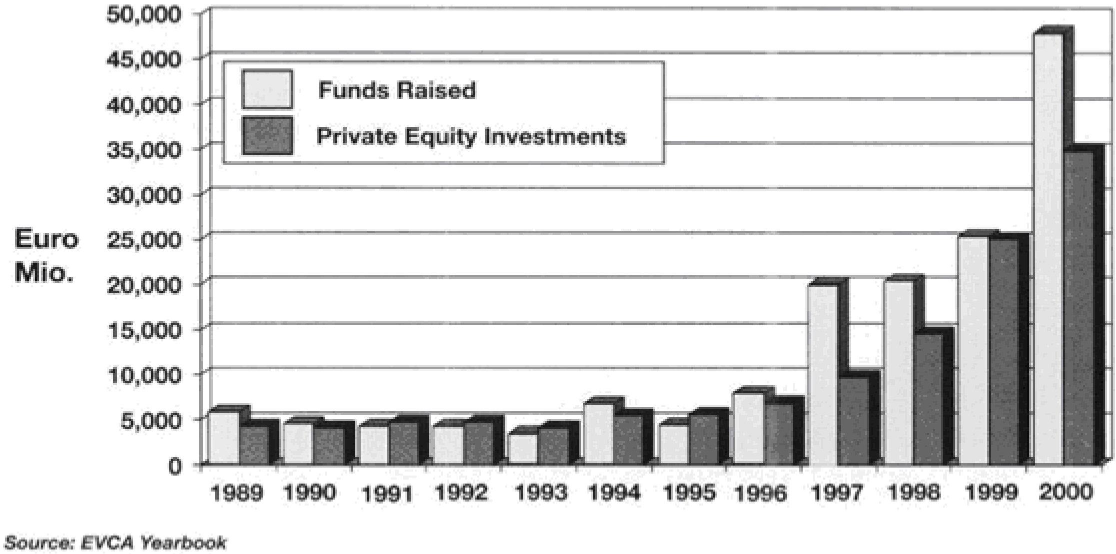
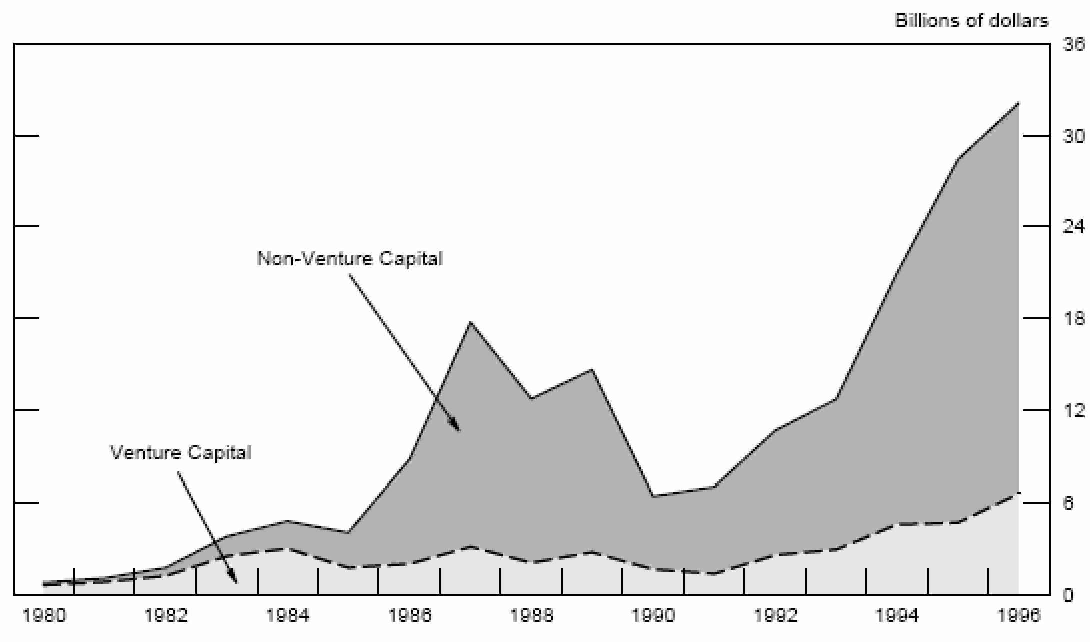
Appendix A - Private equity investments in Europe



The amount of capital raised to private equity funds and the sum of private equity investments in Europe on an annual basis, in millions of Euros with data from EVCA (Arundale, 2002).

Appendix B - Private equity investments in the US



Private equity investments in the US, both venture capital and non venture capital (buyout capital). In billions of dollars (Fenn, Liang & Prowse, 1997).

Appendix C - Interview questions

This is a list of the questions asked during the interview, in order to make it easier to replicate this study the authors have described how the questions were derived, the motive to use them and which of the four theoretical sections they concern. The four sections are corporate governance, financial improvement, operational improvement and value adding interaction.

- **How did the buyout affect the company?**
  This is a probing question to start the interview and the objective with this question, except to start a conversation, was to perceive the respondents sentiment towards the buyout.

1) **How does the private equity firm contribute?**
   This question was derived from Meier's (2006) theory about private equity firms' interaction with their portfolio companies. It is also relevant to Singh's (1990) research which shows an increase in shareholders' board representation after a buyout. The question concerns both *corporate governance* and *value adding interaction.*

2) **Has the private equity firm improved the operating performance?**
   According to Berg and Gottschalg (2005) cost cutting, better productivity, reduced capital requirements and change of underperforming managers can lead to increased operating performance in buyouts. This question is asked in order to find if the private equity firms improve their portfolio companies in these areas. The question concerns *operational improvement.*

3) **Has the private equity firm changed the strategy or focus of the company?**
   Easterwood et. al. (1989) states that debt repayment can force a company to divest unprofitable division an increase the focus of the core business. According to Berg and Gottschalg (2005) strategic refocusing can also be a significant source of value. The authors have chosen this question to observe if the private equity firms have changed the strategy or focus of the company. The question concerns *operational improvement.*

4) **Has the private equity firm assisted in acquisitions?**
   This question is derived from the study by Seth and Easterwood (1993) which points out expansion by acquisition to be a common strategy for private equity firms. The authors also wanted to include the question as we have hypothesized if the private equity firms' capital strength makes growth by acquisitions an attractive strategy. Finally the involvement by the private equity firm in acquisitions can demonstrate in which areas they contribute, i.e. financially or consultative. The question concerns *operational improvement, financial improvement* and *value adding interaction.*

5) **Has the private equity firm contributed with new contacts or customers?**
   This question is of less importance and is linked to the contacts the private equity firm and industry experts potentially can provide (Meier, 2006). Potentially private equity firms also can assist in contacts with financial institutions and banks (Berg & Gottschalg, 2005). Just as question number four this question has also been derived from the authors own assumptions. As private equity firms have several companies in their portfolios it could be possibility that they would encourage exchange between them. The question concerns *operational improvement, financial improvement* and *value adding interaction.*

6) **Have the private equity firm implemented incentives programs or given executives an equity stake?**
This question is developed from Phan and Hill's (1995) research which shows that incentives programs and equity stakes for management is important in the alignment owners and managers interest. The question concerns *corporate governance*.

7) **Does the private equity firm assist in or influence recruitments?**
The question stems from Meier's (2006) research which shows that it is important for the private equity firms to replace underperforming managers and be active in the recruitment process by using external recruiters. The question concerns *value adding interaction*.

8) **Has the private equity firm changed the financial operations?**
This question includes financial operations on both the left and right side of the balance sheet, additionally the financial reports the private equity requires demonstrate which information they demand and therefore give response to Meier's (2006) research. For the right side of the balance sheet this includes i.e. recapitalization and renegotiations of bank term (Gupta & Rosenthal, 1991. Berg & Gottschalg, 2005). Finally, indirectly the debt repayments relate to the agency cost of free cash flow (Jensen, 1986). The question concerns *operational improvement, financial improvement and corporate governance*.

9) **Within which area has the most prominent changes been made?**
This question is included as an extra question to identify which section has seen the most prominent changes, and to get further clarification.

Appendix D - Information to the respondents

These are the questions and guidelines sent to the respondents by mail before the interview. Additionally this thesis purpose and problem statement were included.

Frågorna är förhållandevis breda och kan ses som riktlinjer på vad vi gärna skulle vilja veta. De områden som är svåra att svara på kan ni lämna blanka och omvänt där ni kan ge mycket feedback så får ni gärna utveckla svaret. Självklart behöver ni inte svara på de frågor som är för känsliga i relationen till era ägare och givetvis får ni vara anonyma.

Frågor

1. Hur har Private Equity bolaget bidragit?
2. Har Private Equity bolaget bidragit till effektivisering av verksamheten?
3. Har Private Equity bolaget bidragit till förändring av strategi i verksamheten?
4. Har Private Equity bolaget bistått vid förvärv?
5. Har Private Equity bolaget bidragit med nya Kontakter/Kunder?
6. Har Private Equity bolaget utformat belöningssystem eller liknande?
7. Har Private Equity bolaget påverkat vid rekrytering?
8. Har Private Equity bolaget förändrat det finansiella arbetet?
9. Inom vilket område har det skett störst förändringar?