Adams Street

INSIGHTS
DECEMBER 2019

Examining European Sponsor-to-Sponsor Transactions

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While not a new phenomenon, sponsor-to-sponsor transactions[1] continue to be viewed skeptically by investors and other industry participants. Perhaps this is because these types of transactions are less understood or due to a lack of available information and data on the subject.

The concerns typically cited by investors regarding sponsor-to-sponsor transactions include:

1. They are “pass-the-parcel” deals to boost deployment
2. The same investor can end up being both the buyer and the seller, which creates a frictional cost to owning the same asset
3. There is little room for further operational improvement when a sponsor has already owned the business
4. The deals are dependent on favorable debt markets
5. Buyers end up overpaying for sponsor-owned assets

In this paper we take a closer look at transactions between sponsors by analyzing approximately 500 realized European buyout investments and evaluating the points outlined above. Key takeaways include:

- **Sponsor-to-sponsor deals account for approximately 50% of the deal value and 30% of transactions**
- **Larger deals generally tend to have a greater percentage of sponsor-sourced transactions**
- **On average, sponsor-to-sponsor transactions attract higher prices and utilize higher levels of leverage**
- **Sponsor-to-sponsor deals have more stable returns with lower losses, while non-sponsor deals have greater dispersion and propensity to outperform**

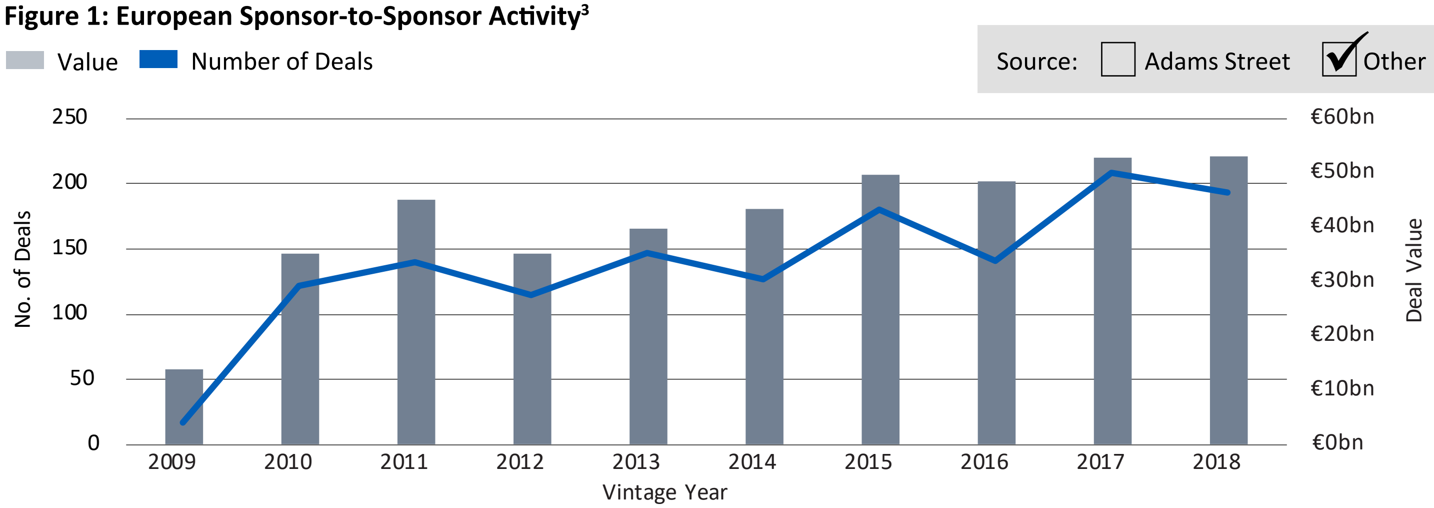
1. Also known as a secondary buyout, a sponsor-to-sponsor transaction occurs when a financial sponsor sells its investment in a company to another financial sponsor.

“Sponsor-to-sponsor transactions account for approximately half of the deal value and 30% of deals by number”

The European Market

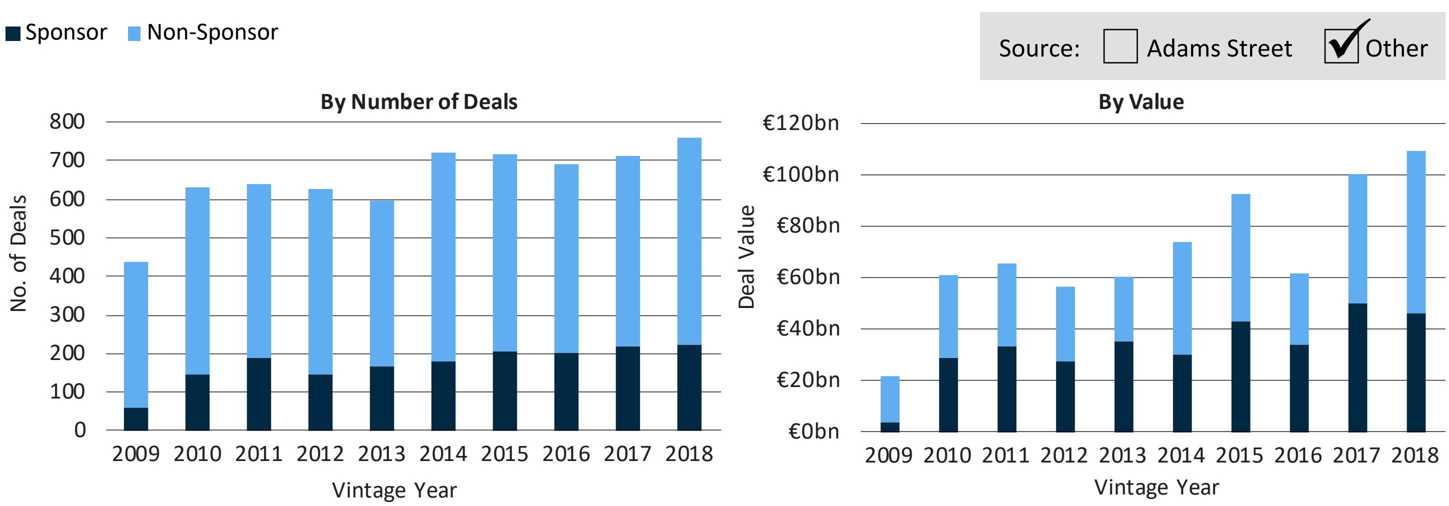
As the European buyout market recovered post-Global Financial Crisis (“GFC”) and returned to growth so did the volume and frequency of sponsor-to-sponsor transactions. Figure 1 illustrates the growth in deals between sponsors with the number of transactions increasing by 25% and the value nearly doubling between 2010 and 2018. Although we focus on the European market in this paper, we observed similar trends in North America in prior research.[2] In terms of regional differences, sponsor-to-sponsor activity is higher in relatively more developed European Private Equity markets.

Figure 1: European Sponsor-to-Sponsor Activity[3]



Below we compare sponsor-to-sponsor transactions against overall European buyout transaction volume. We found evidence that on a relatively consistent basis these transactions account for approximately half of the deal value and 30% of deals by number (Figure 2).

Figure 2: Sponsor-to-Sponsor Activity within the European Buyout Market[4]



We conclude from the illustrative data that sponsor-to-sponsor transactions represent a material part of the European buyout market.

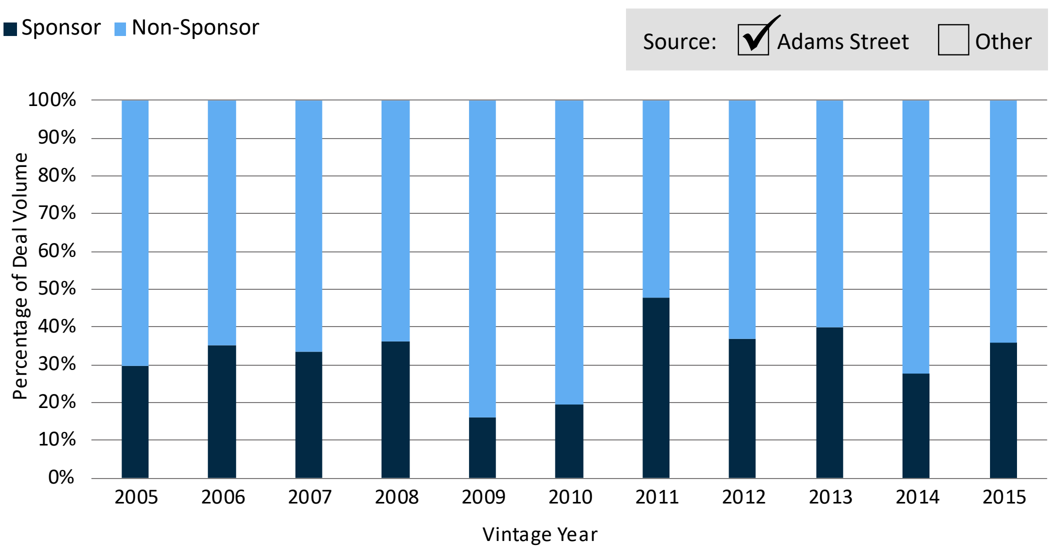
2. Source: PitchBook’s 2018 Annual US PE Breakdown report.
3. Source: CMBOR European Buy-Outs Report Full Year 2018.
4. Source: CMBOR European Buy-Outs Report Full Year 2018. Vintage year defined as the year during which the transaction closed.

Data and Analysis

Adams Street has actively invested in Europe since 1997, deploying more than €6 billion across 200+ primary funds. We are therefore in a position of having a large dataset to analyze. Our analysis focuses on European buyout investments made between 2005 and 2015 that have been realized.[5] The large sample of approximately 500 deals spans more than 10 years and a full economic cycle.[6]

Adams Street's sample is broadly in line with the market, in terms of the number of sponsor-to-sponsor transactions each year, at around one-third (Figure 3). While we observe higher activity at the larger end of the market, as measured by fund size, it is prevalent across all fund sizes. When we look at the data broken down by Enterprise Value, a similar trend emerges with sponsor-to-sponsor activity generally higher in larger deals. However, there is a decrease in activity in the largest deals,[7] as this segment includes a number of public-to-private and corporate carve-out deals. The small end of the market predominately features deals bought directly from founders and management that often end up being sold to another sponsor.

Figure 3: Sponsor to Sponsor Deals within Adams Street's Sample, by Number[6,8]

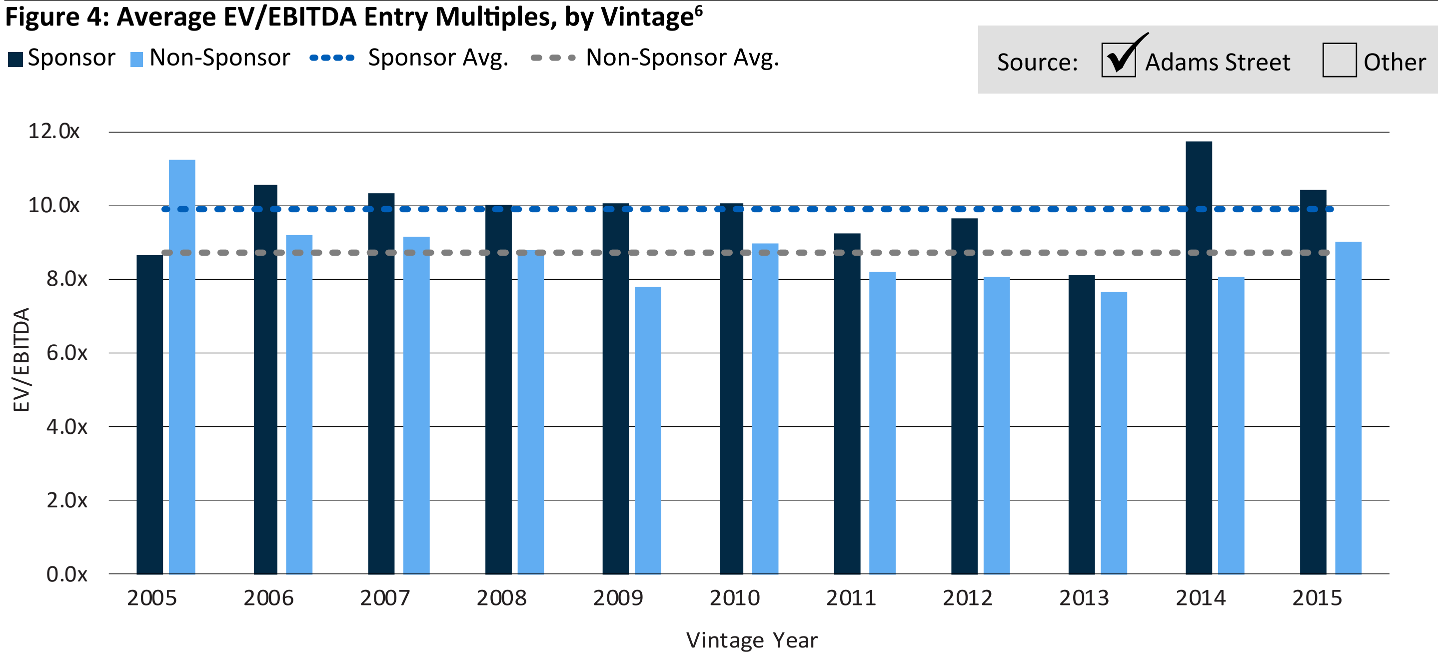


One of the criticisms raised in relation to sponsor-to-sponsor transactions is that the buyer overpays for the asset. Figure 4 plots the average entry multiples (EV/EBITDA) paid in each vintage year for assets acquired from sponsors and non-sponsors, along with the average across the entire sample period for each category.

5. Includes partial realizations where at least cost was returned.
6. Adams Street Partners Investment Research Explorer ("ASPIRE") as of December 31, 2018. Includes all realized and partially realized investments where at least cost was returned. Sample covers investments closed between 2005-2015 by European buyout funds in which Adams Street Partners invested in on a primary basis.
7. Transactions with an Enterprise Value of more than €1 billion.
8. Vintage year defined as the year during which the transaction closed.

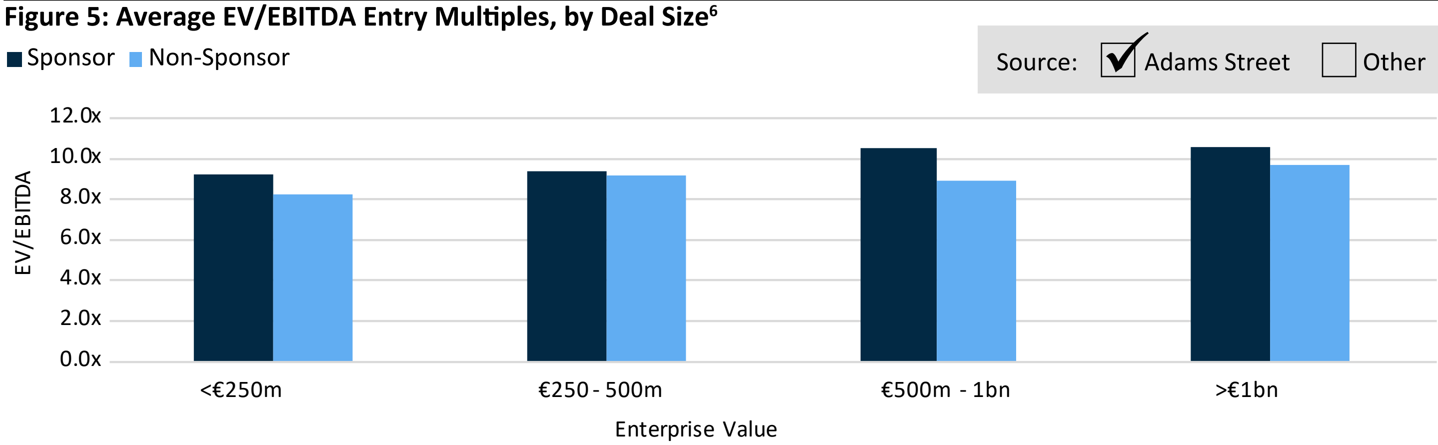
> **"Assets acquired from another sponsor consistently attract higher prices, irrespective of deal size"**

Figure 4: Average EV/EBITDA Entry Multiples, by Vintage[6]



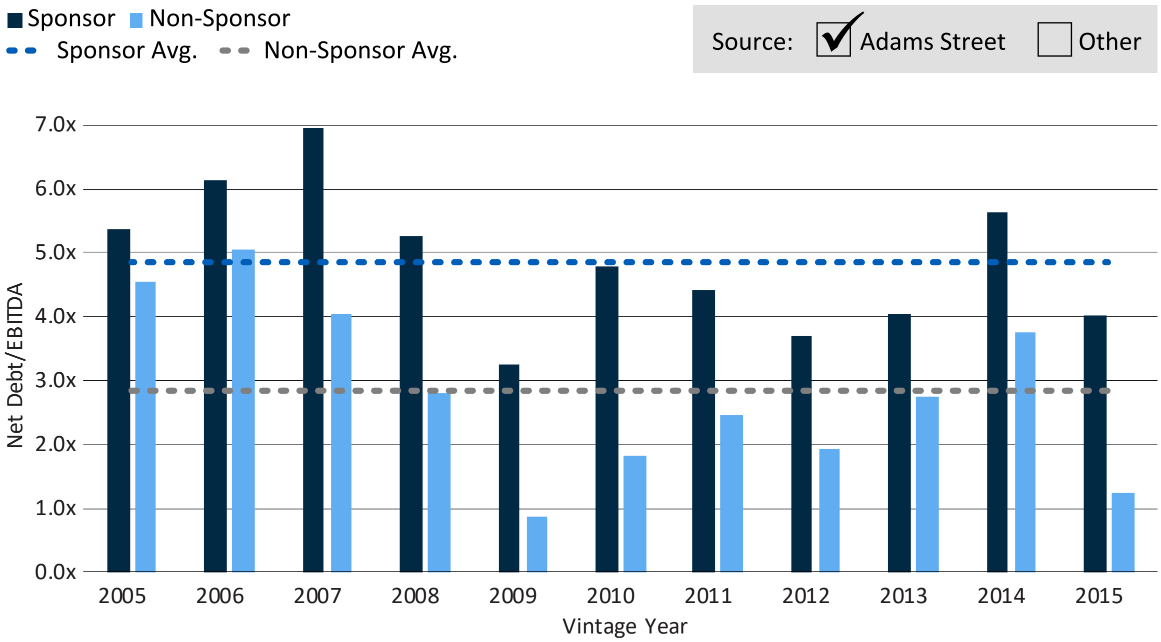
Based on the transaction sample this concern appears valid. Assets acquired from other sponsors transact at approximately one turn of EBITDA higher than those acquired from other sources. Why is that? In Adams Street's view, this might be because they are larger businesses with better management teams or "cleaner" assets with more diversified revenue streams. Or, perhaps sponsor-owned businesses are sold in very efficient processes that generate a higher price. Another explanation could be that sponsor-to-sponsor transactions involve larger assets, which themselves tend to attract higher purchase prices. However, in Adams Street's sample we found that assets acquired from another sponsor consistently attract higher prices, irrespective of deal size (Figure 5).

Figure 5: Average EV/EBITDA Entry Multiples, by Deal Size[6]



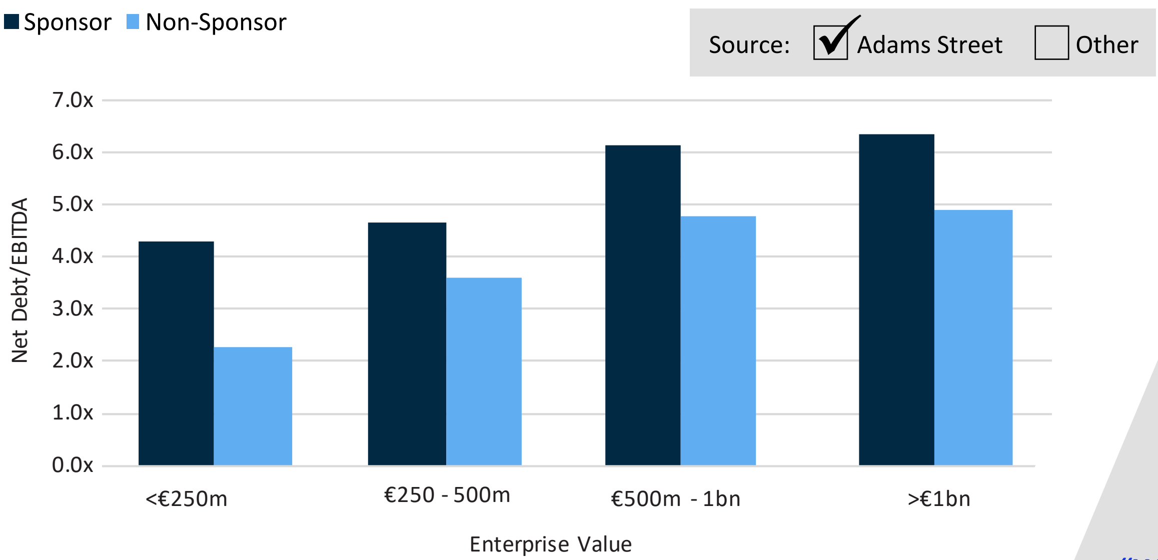
What about leverage and a dependence on favorable financing markets? Adams Street's analysis suggests a higher level of dependence for sponsor-to-sponsor transactions as these deals utilize significantly higher levels of leverage, two turns Net Debt/EBITDA more on average than non-sponsor deals (Figure 6). There could be several reasons for this, including: having previously been private equity-owned, the company's management has experience working with leverage and/or a track record of performing with higher levels of debt; and lenders may be more familiar with assets previously sponsor-owned and therefore more comfortable lending to them, possibly at higher levels than before. In our experience, part of the explanation is simply that higher priced sponsor deals require more leverage on average.

Figure 6: Average Entry Net Debt Multiples, by Vintage[6]



As highlighted by Figure 7, the same trend is clear irrespective of deal size. While total leverage is higher for larger transactions, sponsor-sourced deals consistently utilize between 1x-2x EBITDA more of debt at entry.

Figure 7: Average Entry Net Debt Multiples, by Deal Size[6]

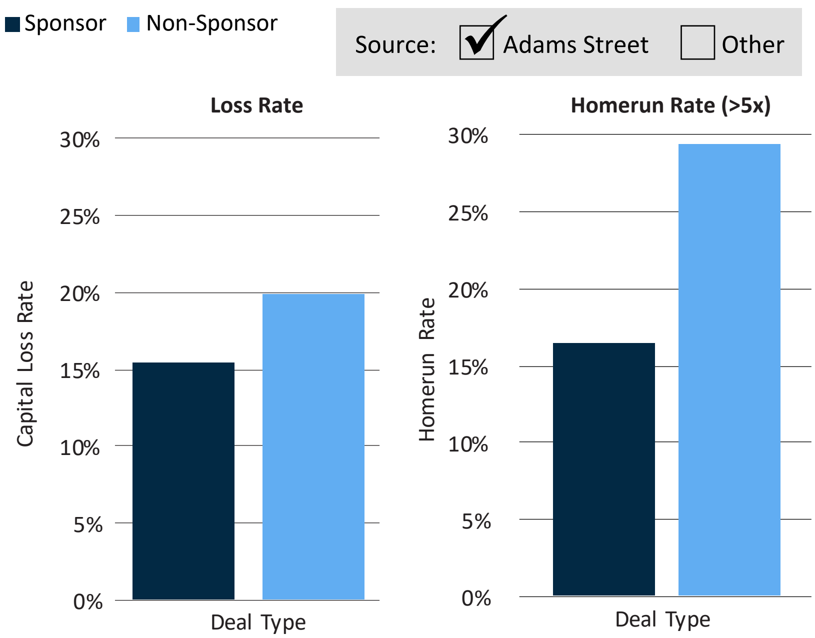


Next, we analyze the dispersion of returns and more specifically loss rates[9] and homerun rates[10], metrics used by Adams Street in assessing manager performance (Figure 8). We find that sponsor-to-sponsor deals within Adams Street's sample generate more stable returns with lower losses. While sponsor-to-sponsor deals have higher financial risk due to higher leverage on average, they appear to offer lower operational risk based on the loss rate analysis. At the same time

"While total leverage is higher for larger transactions, sponsor-sourced deals consistently utilize between 1x-2x EBITDA more of debt at entry"

9. Loss Rate: percentage of fund capital in deals realized below cost, net of any recovered proceeds, over the total amount invested.
10. Homerun Rate: transactions generating more than 5x the total amount invested or Multiple of Invested Capital ("MOIC").

Figure 8: Loss Rate and Homerun Rate[6, 12]

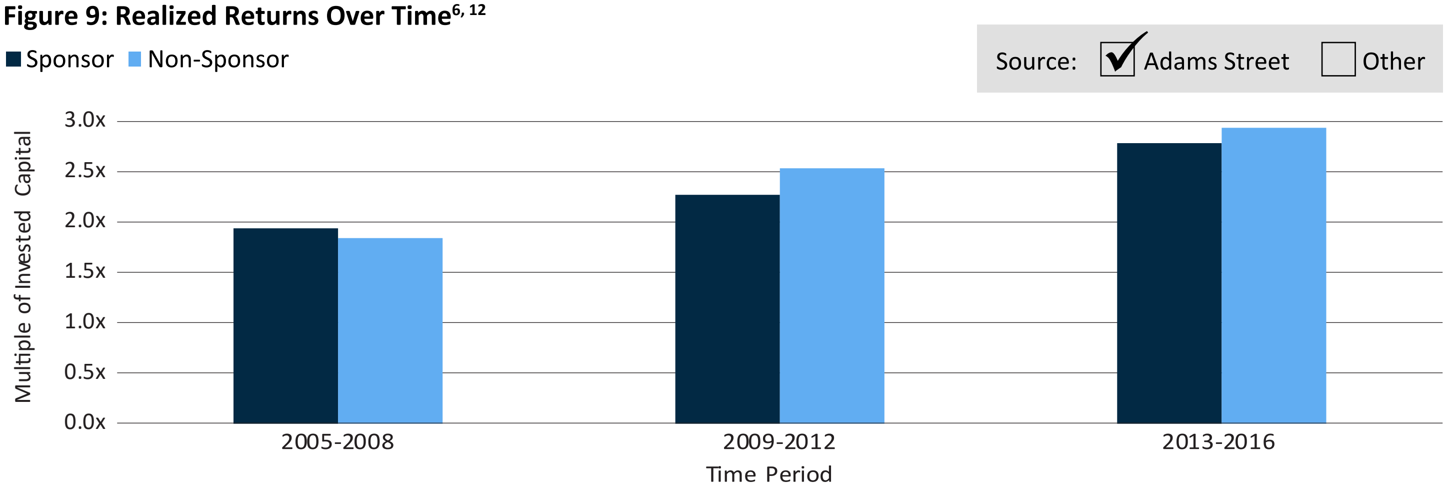


"We find that sponsor-to-sponsor deals within Adams Street's sample generate more stable returns with lower losses"

sponsor-to-sponsor deals display a lower propensity to outperform (15% vs. 30% homerun rate by invested capital). As such, sponsor-to-sponsor deals appear to offer a more banded return profile with lower downside risk and capped upside. Interestingly the sponsor-sourced homerun transactions were mainly mid-market[11] businesses whereas the non-sponsor homeruns had a barbell distribution, either being small or very large (complex carve-outs or public-to-private transactions).

Finally, to compare the returns between sponsor-sourced transactions and those acquired through other channels, the sample is split into three time periods (pre-GFC, post-GFC, and more recent years). As illustrated in Figure 9, there is little variance in returns across the time series depending on the deal source. Across the entire time period we find the sponsor and non-sponsor returns to be almost identical. Loss rates for sponsor and non-sponsor transactions are broadly the same for the 2005-2008 period at approximately 25%. However, sponsor-sourced deals exhibit significantly lower loss rates during the two more recent time periods at less than half of that for non-sponsor deals. Adams Street is cognizant that a large portion of the data set covers an upmarket period and therefore may not accurately reflect loss rates, particularly in more recent periods, or on a go-forward basis.

Figure 9: Realized Returns Over Time[6, 12]



11. Mid-market defined as transactions with an Enterprise Value between €250 million and €1 billion.
12. MOIC calculated as realized proceeds, plus any remaining unrealized value over the total amount invested, gross of general partner fees, carried interest and expenses

Conclusion

Sponsor-to-sponsor transactions exhibit a more banded return profile with lower downside and capped upside. Adams Street also finds no evidence of underperformance in sponsor-to-sponsor transactions in our sample of approximately 500 realized European buyout investments. However, in our experience, assets acquired from other sponsors generate those same returns with higher levels of leverage. Adams Street recognizes the positive effect additional leverage has on sponsor-to-sponsor returns in a relatively favorable market environment with generally low loss rates. Adams Street acknowledges that this could potentially reverse under different market conditions. Based on this research, Adams Street believes that sponsors are a relevant source of deal flow for other sponsors, provided that one is selective in backing managers with sector expertise and the operating skill to drive returns irrespective of how deals are sourced.

Adams Street Partners is a global private markets investment manager with investments in more than thirty countries across five continents. Drawing on 45+ years of private markets experience, proprietary intelligence, and trusted relationships, Adams Street strives to generate actionable investment insights across market cycles. Adams Street is 100% employee-owned and has approximately $40 billion in assets under management. Adams Street has offices in Beijing, Boston, Chicago, London, Menlo Park, Munich, New York, Seoul, Singapore, and Tokyo.

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